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Federal Income Taxation of Wealth Transfers on Divorce: A Policy Analysis and Proposal

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FEDERAL INCOME TAXATION OF WEALTH TRANSFERS ON DIVORCE: A POLICY ANALYSIS AND PROPOSAL

by

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Editor's Note: Unless otherwise indicated all statutory references are to the Internal Revenue Code of 1954, as amended, which is codified in title 26 of the United States Code. Internal Revenue Code sections are cited to the 1976 permanent edition and/or current supplement of the United States Code, if therein. Otherwise, code sections are cited to the main edition and/or current supplement of the United States Code Annotated published by West Publishing Company. All Treasury Regulations are cited by section number and may be found in 26 C.F.R. (1983) unless otherwise indicated.

THE termination of a marriage is undoubtedly a traumatic event. Emotions are frayed by the rending of a relationship often entered into with the promise of love "until death do us part." Difficult emotional and practical problems also arise when agreement on the custody of children is required. The division of marital property according to the requirements of state law, and sometimes equity, presents another practical problem. Indeed, with the growth in numbers of childless marriages and two career families, disputes over property division may well replace custody battles as the repository for the emotional bloodletting of a dissolving marriage. The federal income tax system imposes onto all of this a complex array of rules fraught with traps for the unwary. Couples with even moderate wealth require counsel knowledgeable in the intricacies of federal tax law in order to avoid unexpected tax liability. Often a division that appears equal before tax will be grossly disproportionate after the tax assessment.

This Article explores various provisions taxing the transfer of wealth on divorce. Although the principle focus of the Article is on the division of property between separating spouses, some consideration is given to the regime for splitting post-divorce earnings between the parties in the form of alimony or support payments. The Article recommends congressional action providing uniform national treatment for property divisions on divorce with basis provisions to insure equitable after-tax division.

I. OVERVIEW

There are, in general, three categories of wealth transfer between separating spouses. The first is the periodic transfer of post-divorce income. The burden of income taxation falls on the recipient of support or alimony pursuant to an approved form of income splitting.[1] A second set of rules deals with the lump sum transfer of cash or property, or the periodic transfer of a fixed amount, in satisfaction of support or other marital obligations.[2] In contrast with the first regime, this category does not shift the burden of taxation to the recipient of property. The tax burden is shared by the marital community when cash previously reported as income on a joint return is used.[3] Where appreciated property is transferred in satisfaction of a marital obligation, the tax burden for pre-divorce appreciation

1. *See* I.R.C. §§ 71(a), 215 (1976).
2. Payment of an ascertainable sum is not covered by the income splitting mechanism of § § 71 and 215. *See id.* § 71(c).
3. The tax burden is shared because previously earned cash has presumably been accounted for by the parties on their joint return, generating tax consequences for which both spouses are liable. *Id.* § 6013(d)(3) (1976).

falls on the transferor.[4] The transferee is not taxed on the receipt of property and receives it with a basis equal to fair market value.[5] The final category is the division of co-owned property. A division of jointly owned property is generally not a taxable event,[6] and the recipient retains the marital community's basis.[7] The burden of taxation for pre-divorce appreciation, however, falls on the recipient of such property upon subsequent disposition. Each of these categories will be considered as part of a search for common principles that unify the treatment of wealth transfer on divorce.

II. PERIODIC TRANSFER OF POST-DIVORCE INCOME: SPOUSAL SUPPORT AND ALIMONY

In 1917 the United States Supreme Court held in *Gould v. Gould*[8] that alimony paid by a husband to his ex-wife was neither includible in the wife's income nor a decrease in the gross income of the divorced husband.[9] In 1942 Congress concluded that alimony payments plus the income tax on earnings used to pay alimony could exceed the obligor's actual income.[10] Congress sought to correct this situation by taxing alimony and separate maintenance payments to the recipient spouse and allowing a deduction to the payor.[11] The House and Senate committee reports indicate that this provision was intended to produce uniformity in the treatment of alimony payments regardless of differing state law and to clarify the tax consequences of payments out of the net income of so-called irrevocable alimony trusts.[12]

As originally enacted, section 22K of the Internal Revenue Code of 1939[13] applied only to an obligation arising out of the family or marital relationship in recognition of a general obligation to support made specific by an instrument or decree of divorce or separation.[14] The 1954 Code ex-

4. United States v. Davis, 370 U.S. 65, 70-72 (1962).
5. Rev. Rul. 67-221, 1967-2 C.B. 63.
6. Carrieres v. Commissioner, 64 T.C. 959 (1975), *acq.* 1976-2 C.B. 1, *aff'd per curiam*, 552 F.2d 1350 (9th Cir. 1977); Walz v. Commissioner, 32 B.T.A. 718 (1935).
7. *See, e.g.*, Carrieres v. Commissioner, 64 T.C. 959, 964 (1975), *acq.* 1976-2 C.B. 2, *aff'd per curiam*, 552 F.2d 1350 (9th Cir. 1977), Wren v. Commissioner, 24 T.C.M. (CCH) 290, 294 (1965); Oliver v. Commissioner, 8 T.C.M. (CCH) 403, 430 (1949).
8. 245 U.S. 151 (1917).
9. *Id.* at 154. The Court described alimony as follows:

> Alimony does not arise from any business transaction, but from the relation of marriage. It is not founded on contract, express or implied, but on the natural and legal duty of the husband to support the wife. The general obligation to support is made specific by the decree of the court of appropriate jurisdiction. . . . Permanent alimony is regarded rather as a portion of the husband's estate to which the wife is equitably entitled, than as strictly a debt; alimony from time to time may be regarded as a portion of his current income or earnings; . . . .

Id. at 153 (quoting Audubon v. Shufeldt, 181 U.S. 575, 577-78 (1901)).
10. H.R. REP. No. 2333, 77th Cong., 2d Sess. 46 (1942).
11. *Id.*
12. *Id.* at 69-71; S. REP. No. 673 (pt. 1), 77th Cong., 1st Sess. 32 (1941).
13. Revenue Act of 1942, Pub. L. No. 77-753, § 120, 56 Stat. 798, 816-17.
14. S. REP. No. 673 (pt. 1), 77th Cong., 1st Sess. 32 (1941). Whether a particular obliga-

panded the alimony rules to payments received under a written separation agreement where husband and wife are actually separated and to payments received under a judicial decree of support or maintenance.[15] Thus the current provision, section 71(a) of the Internal Revenue Code of 1954, taxes the recipient on periodic payments that are received in discharge of a marital or family obligation under either a decree or written instrument incident to divorce or separation or pursuant to a written separation agreement, and payments received pursuant to a judicial decree for support or maintenance.[16] Payments included in gross income of the recipient by virtue of section 71(a) are deductible by the payor under section 215.[17]

Under this statutory scheme a couple may freely arrange for the splitting of income at each stage of the breakup of their marriage, as long as the

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tion was imposed by a decree of divorce or separate maintenance within the meaning of the statute has been extensively litigated. *See, e.g.*, Hand v. Commissioner, 31 T.C.M. (CCH) 1125 (1972), *aff'd mem.*, 483 F.2d 1399 (2d Cir. 1973); Reisman v. Commissioner, 49 T.C. 570 (1968), *acq.* 1972-2 C.B. 3; Christopher v. Commissioner, 18 T.C.M. (CCH) 521 (1959).

15. I.R.C. § 71 (1976). The House report indicated that the prior provision discriminated against husbands and wives who had separated, although not under a court decree. H.R. REP. No. 1337, 83d Cong., 2d Sess. 10 (1954). The House bill included what is now I.R.C. § 71(a)(2) (1976), which applies to support payments under a written separation agreement. *See* H.R. REP. No. 1337, at 10. The Senate Finance Committee concurred and added I.R.C. § 71(a)(3) (1976) providing for support payments pursuant to a judicial decree for support or maintenance. S. REP. No. 1622, 83d Cong., 2d Sess. 170-71 (1954).

16. I.R.C. § 71(a) (1976) provides:

> (1) Decree of divorce or separate maintenance
>
> If a wife is divorced or legally separated from her husband under a decree of divorce or of separate maintenance, the wife's gross income includes periodic payments (whether or not made at regular intervals) received after such decree in discharge of (or attributable to property transferred, in trust or otherwise, in discharge of) a legal obligation which, because of the marital or family relationship, is imposed on or incurred by the husband under the decree or under a written instrument incident to such divorce or separation.
>
> (2) Written separation agreement
>
> If a wife is separated from her husband and there is a written separation agreement executed after the date of the enactment of this title, the wife's gross income includes periodic payments (whether or not made at regular intervals) received after such agreement is executed which are made under such agreement and because of the marital or family relationship (or which are attributable to property transferred, in trust or otherwise, under such agreement and because of such relationship). This paragraph shall not apply if the husband and wife make a single return jointly.
>
> (3) Decree for support
>
> If a wife is separated from her husband, the wife's gross income includes periodic payments (whether or not made at regular intervals) received by her after the date of the enactment of this title from her husband under a decree entered after March 1, 1954, requiring the husband to make the payments for her support or maintenance. This paragraph shall not apply if the husband and wife make a single return jointly.

The terms "husband" and "wife" are used interchangeably and refer to a former husband or wife as well. *Id.* § 7701(a)(17).

17. *Id.* § 215(a) provides:

> In the case of a husband described in section 71, there shall be allowed as a deduction amounts includible under section 71 in the gross income of his wife, payment of which is made within the husband's taxable year. No deduction shall be allowed under the preceding sentence with respect to any payment if, by reason of section 71(d) or 682, the amount thereof is not includible in the husband's gross income.

arrangement meets the various statutory requirements.[18] Although the statute by its terms is mandatory, parties with adequate sophistication may treat sections 71 and 215 as an election by meeting or failing to meet the various statutory requirements.[19] Some commentators suggest that the function of the various substantive requirements of sections 71 and 215 is to distinguish periodic payments out of current earnings that deflect current income from payments made to divide existing property interests.[20] Even if Congress did not expressly consider this analysis, it is consistent with the economic result of the statute. As a practical matter, where a qualifying payment[21] is made over a period of time following divorce, the source of payment will be the payor's current income. The statutory scheme taxes the recipient on this current income even though the income is earned by the payor.[22] Conversely, where existing property interests are divided at divorce, there is usually no current tax burden to allocate, and therefore no reason for an income splitting mechanism. In the latter case the hardship avoided by sections 71 and 215 may not exist[23] since a spouse receiving his or her own property will bear the burden of taxation only upon disposition of that property. If this analysis of the statutory scheme is correct, our inquiry should focus on whether the specific requirements of the Code distinguish a settlement of property interests and a division of future income as clearly as is possible or even desirable.

The first substantive requirement of section 71(a)(1) provides that the obligation to pay alimony must arise under either a decree of divorce or separate maintenance, or a written instrument incident to such divorce or

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18. Certainly, complete contractual freedom to fix the tax consequences of periodic payments does not exist. Professor Sneed, now a federal circuit judge, comments:

> While dogmatism in a matter of this kind is not possible, this partial contractual freedom requires that the question be asked why complete freedom should not exist. It is at least arguable that, to the extent the marriage relationship becomes more consensual by means of removal of legal impediments to divorce, so should the income tax consequences of the financial arrangements incident to divorce. As it is, the structure is a somewhat curious blend of status and contract—a blend, however, which is no more curious than that reflected by the local laws of divorce.

S. SNEED, THE CONFIGURATION OF GROSS INCOME 271 (1967).

19. This "election" must be carefully planned since one party may attempt to remake the parties' agreement either to avoid tax or obtain a deduction. *See* Pierce v. Commissioner, 66 T.C. 840 (1976) (appeal dismissed nol. pros.), *acq*. 1978-1 C.B. 2; Bishop v. Commissioner, 55 T.C. 720 (1971). *See generally* Lewis, *Income Tax Planning at Divorce or Separation*, 5 OKLA. CITY U.L. REV. 445, 454-55 (1980) (discussion of interjection of one party's intent into ambiguous agreement); Note, *Taxation of Divorce Settlement and the Property/Support Distinction*, 55 S. CAL. L. REV. 939, 950-53 (1982) (citing cases where party successfully restructured agreement).

20. Halpert, *Planning for Shifting Taxable Income in Divorce and Separation*, 37 INST. ON FED. TAX'N § 34.02[7], at 34-14 (1979); Steines, *A Reappraisal of the Taxation of Wealth Transfers Incident to Divorce*, 56 WASH. L. REV. 217, 230 (1981); Note, *supra* note 19, at 944.

21. The payment is qualifying if it falls within the parameters of I.R.C. § 71(a) (1976).

22. This is true whether the payment is contingent on some future event, such as death or remarriage, which guarantees alimony treatment, see Treas. Reg. § 1.71-1(d)(3)(i)(*a*), or is a fixed sum payable periodically over some future period of time.

23. *See* Note, *supra* note 19, at 943.

separation.[24] Subdivision (a)(2) applies only where payments are made pursuant to a written separation agreement.[25] In either case, voluntary payments in the absence of a writing will not qualify.[26] This requirement sensibly limits income splitting to cases where the payor's obligation is manifested in a writing and avoids ad hoc allocations of taxable income.[27] The writing requirement is automatically satisfied in section 71(a)(3), which applies to payments under a judicial decree of support or maintenance.[28]

The principal requirement of section 71(a) is that payments be "periodic." This requirement provides one of the primary distinctions between payments for support out of the payor's post-divorce or separation income and a division of property that gives each spouse his or her pre-divorce property interests.[29] Congressional reports do not expressly describe the purpose of the periodic payment requirement, but legislative history indicates that sections 71 and 215 do not tax the spouse on the receipt of prop-

24. I.R.C. § 71(a)(1) (1976). Payments pursuant to a decree of annulment also qualify as alimony under § 71(a)(1). Newburger v. Commissioner, 61 T.C. 457, 460 (1974); Reisman v. Commissioner, 49 T.C. 570, 574 (1968). In Clark v. Commissioner, 58 T.C. 519 (1972), the parties signed a letter agreement modifying the terms of the divorce decree requiring payment of an ascertainable sum over seven years. Absent the contingency specified in the letter, the payments could not qualify as alimony. *Id.* at 525. The letter agreement provided for a reduction of payments to $50 if the wife should remarry. The agreement was not incorporated into the divorce decree because state law required fixing a noncontingent specific sum of alimony. The Tax Court held that the letter agreement constituted a written instrument incident to the divorce sufficient to qualify the payments as alimony. *Id.* at 524. The court said that the phrase "incident to such divorce" used in § 71(a)(1) means incident to the status of divorce rather than incident to the decree of divorce. *Id.* Thus the agreement need not be incorporated in the divorce decree if the legal obligation of support has continued from the time of divorce.

25. I.R.C. § 71(a)(2) (1976). It also requires an actual physical separation. *Id.* The Tax Court has held that an estranged couple residing in the same abode are not separated even though they have little contact or communication. Washington v. Commissioner, 77 T.C. 601, 605 (1981); Delvecchio v. Commissioner, 32 T.C.M. (CCH) 1153, 1155 (1973). The Eighth Circuit Court of Appeals, however, has allowed § 71 treatment for alimony payments even though husband and wife continue to occupy the same residence. Syndes v. Commissioner, 577 F.2d 60 (8th Cir. 1978).

26. Glickler v. Commissioner, 32 T.C.M. (CCH) 405 (1978) (appeal dismissed nol. pros.); Clark v. Commissioner, 40 T.C. 57 (1972); Brown v. Commissioner, 50 T.C. 865 (1968), *aff'd per curiam*, 415 F.2d 310 (4th Cir. 1969); Herrmann v. Commissioner, 23 T.C.M. (CCH) 429 (1964).

27. At least one case has held that a declaration in open court reflected in the written transcript does not satisfy the writing requirements. Greenfield v. Commissioner, 37 T.C.M. (CCH) 1576, 1578 (1978) (affidavit filed in court not sufficient evidence of written agreement); *see also* Sheeley v. Commissioner, 59 T.C. 531, 534 (1973) (oral agreement stipulated to in court and made part of record held not to satisfy requirement of § 152(e)). *But see* Prince v. Commissioner, 66 T.C. 1058, 1067 (1976) (oral agreement stipulated to in open court meets writing requirement of § 71).

28. I.R.C. § 71(a)(3) (1976). Subdivisions (a)(2) and (a)(3) also provide that § 71 treatment does not apply when the parties file a joint return. *Id.* § 71(a)(2)-(3). A joint return accomplishes the same income splitting as the alimony provisions. Including payments in the income of one spouse with a deduction by the other on a joint return would have a net effect of zero with respect to taxable income. A husband and wife are jointly liable for the tax on income in a joint return regardless of which spouse earns the income. *Id.* § 6013(d)(3).

29. Halpert, *supra* note 20, at 34-14.

erty interests he or she possessed before separation.[30] Although the term "periodic payments" is not defined in the Code, section 71(c)(1) provides that periodic payments do not include installment payments in discharge of a principal sum specified in the decree or agreement.[31] Thus the installment payment of a fixed sum is treated as a division of property, rather than a division of the payor's current income.[32] Nonetheless, installment payment of a principal sum is considered periodic and within the coverage of sections 71 and 215 if the fixed sum is payable in installments over a period of more than ten years from the date of the decree or agreement.[33] No more than ten percent of the principal sum, however, will be included in the gross income of the recipient and deductible by the payor in any one year.[34] Presumably Congress believed that a fixed amount payable over more than ten years was payable out of current income, while a fixed sum payable over a shorter period represented a division of marital property. The ten-year requirement has generated substantial litigation and creates a trap for the unwary.[35] Computational errors are common[36] and the ten-year period may also be truncated by an error as to the date of agreement.[37]

30. H.R. REP. No. 2333, 77th Cong., 2d Sess. 72 (1942).

31. I.R.C. § 71(c)(1) (1976). A principal sum is specified in the decree or agreement if a fixed amount may be ascertained from the face of the decree or agreement. An instrument in which the total amount to be paid is stated does not differ from one in which the principal sum must be determined by multiplying the payments by a certain period. Kent v. Commissioner, 61 T.C. 133, 136 (1973); *see* Treas. Reg. § 1.71-1(d)(3)(ii)(*b*).

32. Commissioner v. Senter, 242 F.2d 400, 403 (4th Cir. 1957).

33. I.R.C. § 71(c)(2) (1976); *see also* Wright v. Commissioner, 543 F.2d 593, 599 (7th Cir. 1976) (absence of contingency is not fatal to alimony status).

34. I.R.C. § 71(c)(2) (1976). This requirement prevents the payor from bunching deductions in an earlier year and thereby imposing taxation on the recipient at a higher marginal rate. The 10% limitation does not apply to delinquent installment payments for a prior taxable year. Treas. Reg. § 1.71-1(d)(2).

35. In Furrow v. Commissioner, 292 F.2d 604 (10th Cir. 1961), a divorce decree dated July 20, 1954, ordered the husband to pay alimony of $36,000 at the rate of $300 per month, due and payable on the first of each month. The full $36,000 was thus payable over 120 months. The first payment was due on Aug. 1, 1954, less than one month after the date of the decree, and monthly installments were payable on the first of each month ending on July 1, 1964, a date less than 10 years after the decree. The court therefore disallowed the husband's deduction for alimony payments. *Id.* at 607.

36. The alimony nature of an ascertainable sum payable over more than 10 years is saved in some cases by interpretations of state law allowing payment within a grace period following the date specified in the divorce decree or settlement agreement. *See, e.g.*, United States v. Reis, 214 F.2d 327, 329 (10th Cir. 1954); Tracy v. Commissioner, 70 T.C. 397, 402 (1978). In Hayutin v. Commissioner, 508 F.2d 462 (10th Cir. 1974), the court held that a discretionary provision allowing the husband to accelerate payment of an ascertainable sum did not change the alimony nature of the arrangement under § 71(c)(2), which applies to payments that "*may* be paid over more than a ten year period." *Id.* at 467-68 (emphasis in original).

37. *See* Eno v. Commissioner, 24 T.C.M. (CCH) 1122, 1125 (1965) (husband lost his § 215 deduction because his legal obligation to pay support arose, not from time of the Nebraska district court order granting divorce and setting alimony, but from final divorce decree after wife's appeal to state supreme court); *see also* Joslin v. Commissioner, 424 F.2d 1223 (7th Cir. 1970) (mere approval of property settlement agreement did not constitute legal obligation in Nevada, absent explicit order of divorce court, and thus time period did not reach 10 years). In Newman v. Commissioner, 68 T.C. 494 (1977), a nunc pro tunc order of the divorce court advancing the due date of the first payment allowed the parties to satisfy

An obligation stated as a principal sum will be a periodic payment, whether payable over ten years or not, if payment is subject to the death of either spouse, remarriage of the wife, or change in the economic status of either spouse.[38] Such a contingent payment also escapes the ten-percent limitation of section 71(c)(2). A principal sum cannot be fixed where a contingency may terminate or revise the obligation.[39]

Finally, section 71 requires that periodic payment be made pursuant to a legal obligation that arises "because of the marital or family relationship."[40] Regulations add that "[s]ection 71(a) applies only to payments made because of the family or marital relationship in recognition of the general obligation to support which is made specific by the decree, instrument, or agreement."[41] Like the periodic payment requirement, this provision distinguishes between payments for support, which represent a transfer of current income, and payments in exchange for the recipient's interest in marital property.[42]

The courts generally hold that characterization of an obligation as support (alimony) or a property settlement depends upon the intent of the parties determined from the facts and circumstances of each case.[43] Use of this "intent of the parties" test to distinguish between property settlements and the support right[44] is hardly a stalwart yardstick on which to base tax

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the 10-year requirement. The Tax Court found that the original decree did not reflect the intent of the state court and the nunc pro tunc order was entered to correct a mistake in that decree. *Id.* at 500.

38. *See* Treas. Reg. § 1.71-1(d)(3)(i)(*a*), (ii). Courts generally find that these payments are in satisfaction of an obligation to support. Salapatas v. Commissioner, 466 F.2d 79, 81-82 (7th Cir. 1971); Suarez v. Commissioner, 68 T.C. 857, 864 (1977) (appeal dismissed); Clark v. Commissioner, 58 T.C. 519, 522-23 (1963). In addition, alimony arrangements subject to modification under state law because of changed circumstances are indefinite in amount and therefore periodic payments under § 71(a). Lounsbury v. Commissioner, 37 T.C. 163, 170 (1961), *acq*. 1962-1 C.B. 4, *aff'd on other grounds*, 321 F.2d 925 (9th Cir. 1963).

39. *See* Landa v. Commissioner, 211 F.2d 46, 50 (D.C. Cir. 1954); Baker v. Commissioner, 205 F.2d 369, 375 (2d Cir. 1953); Clark v. Commissioner, 58 T.C. 519 (1972). The presence or absence of a contingency is another area generating substantial litigation.

40. I.R.C. § 71(a) (1976).

41. Treas. Reg. § 1.71-1(b)(4).

42. *See id.* § 1.71-1(c)(4); Steines, *supra* note 20, at 225. This provision has also generated substantial litigation. *See, e.g.*, Landa v. Commissioner, 211 F.2d 46 (D.C. Cir. 1954); Pierce v. Commissioner, 66 T.C. 840 (1976) (appeal dismissed nol. pros.), *acq*. 1978-1 C.B. 2; Martin v. Commissioner, 31 T.C.M. (CCH) 1219 (1972); Thompson v. Commissioner, 50 T.C. 522 (1968).

43. Wright v. Commissioner, 543 F.2d 593, 598 (7th Cir. 1976); West v. United States, 332 F. Supp. 1102, 1106 (S.D. Tex. 1971), *aff'd*, 477 F.2d 563 (5th Cir. 1973). A principal distinction found in the case law, however, is the presence or absence of a contingency. *See, e.g.*, McCombs v. Commissioner, 397 F.2d 4, 8 (10th Cir. 1968) (absence of contingency suggests property settlement); Landa v. Commissioner, 211 F.2d 46, 49 (D.C. Cir. 1954) (court cited provision in agreement terminating payment on wife's death as evidence that support was intended); *see also* Commissioner v. Senter, 242 F.2d 400, 404 (4th Cir. 1957) (payments made over less than 10 years are periodic, not installments, and terminate on death or remarriage); Baker v. Commissioner, 205 F.2d 369, 370 (2d Cir. 1953) (remarriage contingency interpreted to prove periodic payment); Burton v. United States, 139 F. Supp. 121, 125 (D. Utah 1956) (payments need not be characterized as alimony in limited sense to be periodic payments under statute). *See generally* Note, *supra* note 19.

44. Wright v. Commissioner, 543 F.2d 593, 598 (7th Cir. 1976); Phinney v. Mauk, 411 F.2d 1196, 1198 (5th Cir. 1969); West v. United States, 332 F. Supp. 1102, 1106 (S.D. Tex.

planning.[45] The test is particularly troublesome because both parties may agree to an ambiguous arrangement and subsequently take inconsistent positions with respect to their initial intent.[46] The courts have generally relied on such factors as the extent of a spouse's property interest under state law,[47] the extent to which higher periodic payments were negotiated in exchange for an interest in property,[48] evidence of a correlation between the amount of the installment payments and a spouse's interest in property,[49] and whether support is provided for with some other form of payment.[50] Regardless of these factors, payments extending over a substantial period must come from the current income of the payor. As a consequence, the hardship sought to be avoided by the statutory scheme, taxation of the payor on payments made to an ex-spouse, exists whether payment is in exchange for the recipient's interest in marital property, or in satisfaction of the recipient's right to support. Because of the potential for reclassifying payment of a principal sum as a property division, a degree of uncertainty surrounds any such arrangement.[51]

The statutory goal of taxing the recipient on recurring payment of cur-

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1971), *aff'd*, 477 F.2d 563 (5th Cir. 1973); Suarez v. Commissioner, 68 T.C. 857, 861 (1977); Prince v. Commissioner, 66 T.C. 1058, 1063 (1976).

45. This distinction between alimony and a property division is particularly unclear in a common law jurisdiction. In making equitable provision for a spouse courts often ignore the alimony-property distinction. *See* H. CLARK, THE LAW OF DOMESTIC RELATIONS IN THE UNITED STATES 451 (1968). As a practical matter the support right may be characterized as a property interest in both the husband's current assets and a future interest in the husband's prospective income and assets. The financial satisfaction of the wife's rights must come from one of these sources.

46. *See, e.g.*, Wright v. Commissioner, 543 F.2d 593 (7th Cir. 1976).

47. Riddell v. Guggenheim, 281 F.2d 836, 841 (9th Cir. 1960).

48. McCombs v. Commissioner, 397 F.2d 4, 8 (10th Cir. 1968); Bishop v. Commissioner, 55 T.C. 720, 725-28 (1971); Presbrey v. Commissioner, 29 T.C.M. (CCH) 379, 382 (1970).

49. Porter v. Commissioner, 388 F.2d 670, 671 (6th Cir. 1968); Schottenstein v. Commissioner, 75 T.C. 451, 461-62 (1980), *acq*. 1981-2 C.B. 2.

50. Pierce v. Commissioner, 66 T.C. 840 (1976) (appeal dismissed nol. pros.), *acq*. 1978-1 C.B. 2; Thompson v. Commissioner, 50 T.C. 522 (1968).

51. Recurring payment of a principal sum may be classified as a property settlement rather than alimony. An outright transfer of property may, however, be structured as alimony. I.R.C. § 71(a)(1)-(3) (1976) taxes the recipient on income from property transferred in trust or otherwise as long as the payments are periodic, in satisfaction of the payor's familial or marital obligations, and arise out of a decree of divorce or separation, a written separation agreement, or a judicial support order. Section 71(d) provides that the payor's gross income does not include amounts attributable to transferred property that are included in the gross income of the recipient under § 71(a). *Id.* § 71(d). No corresponding deduction is allowed to the payor under § 215. *Id.* § 215(a).

Section 682 similarly provides that the recipient's gross income includes any amount distributed to her from a trust when she is divorced, legally separated, or receiving payment under a written separation agreement and the income would otherwise be includible in the gross income of the recipient's former spouse. *Id.* § 682. Section 682 is essentially the same as the trust provisions of § 71(a) except that a § 682 trust is created prior to divorce and not in contemplation thereof. Section 682 would include any grantor trust where income is diverted in satisfaction of a spouse's marital obligation. One significant difference exists, however. Section 71 includes all payments in the recipient's income. Section 682 includes only payments that would be income to the grantor. Thus under § 71 the wife is taxable on distributions of corpus while § 682 includes only trust income. *See* C. MARKEY, JR., CALIFORNIA FAMILY LAW PRACTICE AND PROCEDURE ch. 27, at 27-33 (1983).

rent income can be achieved with a simpler system. Congress could face the election squarely by requiring parties to designate in the decree or by agreement that post-divorce payments to a spouse will be taxed to the recipient under section 71.[52] This election would include payments out of current earnings, or from funds generated on sale of the payor's property. As under current law,[53] payments that are contingent on remarriage, death of a spouse, or a change in economic circumstance would be taxed to the recipient and deducted by the payor in all circumstances. Installment payment of a principal sum would be treated as payment in exchange for an interest in property unless both parties affirmatively elect to treat the payment as alimony subject to sections 71 and 215.[54] Such an election eliminates post-divorce tax litigation regarding the intended nature of installment payments. This proposal requires separating spouses to address the issue directly in their negotiations and agree to a binding resolution.[55] If payment in exchange for an existing property interest is intended, the absence of an election would provide appropriate treatment.

The Code already provides for such an election with respect to child support. Section 71(b) provides that section 71(a) will not apply to payments fixed in the decree or agreement for child support.[56] In *Commissioner v. Lester*[57] the Supreme Court held that section 71(b) was not applicable except where payments are specifically designated for child sup-

52. *See* S. SNEED, *supra* note 18, at 292. The Tax Section of the American Bar Association has recommended that parties to a divorce be allowed to specify in the decree or other instrument that any portion of a principal sum or the installment payments is for the purchase of property rights. Any portion of the principal sum or installment payments not so designated would be taxed to the recipient as alimony for purposes of § 71(a). 19 BULL. A.B.A. SEC. TAX. No. 4, at 62-63 (1966).

The Tax Reform Act of 1983, H.R. 4170, 98th Cong., 1st Sess. (1983), proposed by Representatives Rostenkowski and Conable, would define alimony includible in the gross income of the recipient spouse under § 71 to include any payment of cash that is not designated in the divorce or separation instrument as a payment not includible in gross income. The provision would thus provide an election out of § 71 treatment with appropriate language in the decree or agreement. To constitute alimony, liability for the payment could not extend beyond the death of the recipient spouse and the payment must be one of a series of payments where it is reasonable to expect that at least 50% of the amount payable will be paid more than one year after the date on which the first payment is made. *Id.* § 423.

53. Treas. Reg. § 1.71-1(d)(3)(i).

54. The installment payment of a principal sum would be identified under the standards of the current statute; a principal sum is stated in the decree or agreement where it is either set forth expressly or can be calculated from the face of the decree or instrument. Treas. Reg. § 1.71-1(d)(3)(ii)(*b*).

55. There is a transactional cost to the parties in negotiating a settlement agreement or in resolving the question of the election as part of a contested property division. Imposing this cost on the individuals at the time of divorce is less expensive overall than the cost to both the parties and the government of resolution through litigation.

56. I.R.C. § 71(b) (1976) provides:

> Subsection (a) shall not apply to that part of any payment which the terms of the decree, instrument, or agreement fix, in terms of an amount of money or a part of the payment, as a sum which is payable for the support of minor children of the husband. For purposes of the preceding sentence, if any payment is less than the amount specified in the decree, instrument, or agreement, then so much of such payment as does not exceed the sum payable for support shall be considered a payment for such support.

57. 366 U.S. 299 (1961).

port.[58] Thus section 71(b) provides a specific option out of sections 71 and 215. This option is tantamount to an election made in a separation or property settlement agreement or imposed by judicial decree. There is no substantial reason why a similar election with respect to alimony or support in general should not be allowed.

III. Lump Sum Transfers in Satisfaction of Support or Other Marital Rights

In stark contrast to the regime created by sections 71 and 215, wealth transfers in exchange for marital rights not qualified as periodic alimony are received tax free.[59] The tax burden of these transfers may fall equally on each spouse[60] or solely on the payor.[61] The tax free receipt of property in exchange for a release of marital rights by the wife originated in *Gould v. Gould*.[62] That case describes permanent alimony as a portion of the husband's estate to which the wife is equitably entitled.[63] The Supreme Court extended the idea in *United States v. Davis*[64] by implicitly approving the administrative practice of allowing tax free receipt of a lump sum payment of appreciated property in exchange for the wife's release of her inchoate marital rights.[65] The Internal Revenue Service, following the *Davis* rule, stated that marital rights given by the wife in exchange for property are equal in value to the property received.[66] Without advancing any theoretical explanation the Service concluded that there is no gain or loss to the wife on the exchange and her basis in any property received is equal to its fair market value.[67] The courts have also been slow in explaining this theory, but commentators have forwarded differing ideas.

One view holds that the wife's economic gain is a payment for status,[68] and such gains are not generally taxed as income.[69] A slightly more tech-

58. *Id.* at 306.

59. Rev. Rul. 67-221, 1967-2 C.B. 63.

60. *See supra* note 3 and accompanying text.

61. Where payment of a principal sum is not qualified as alimony under § 71 and § 215, the future earnings used to satisfy the obligation are taxed to the payor. Gould v. Gould, 245 U.S. 151, 153 (1917). When appreciated property is transferred in exchange for the transferee's release of marital rights, the transferor is taxable on appreciation occurring prior to the transfer, measured by the difference between fair market value and adjusted basis at the time of transfer. United States v. Davis, 370 U.S. 65, 70-71 (1962).

62. 245 U.S. 151 (1917).

63. *Id.* at 154; *see supra* note 9.

64. 370 U.S. 65 (1962).

65. *Id.* at 73-74 & n.7.

66. Rev. Rul. 67-221, 1967-2 C.B. 63.

67. *Id.*

68. S. SNEED, *supra* note 18, at 265; Barton, *Tax Aspects of Divorce and Property Settlement Agreements—The* Davis, Gilmore *and* Patrick *Cases*, 16 S. CAL. TAX INST. 421, 438 (1964); Note, *Property Transfer Pursuant to Divorce—Taxable Events?*, 17 STAN. L. REV. 478, 481 (1965).

69. S. SNEED, *supra* note 18, at 107-08; *see* 1 S. SURREY, W. WARREN, P. MCDANIEL & H. AULT, FEDERAL INCOME TAXATION 139-42 (1972) [hereinafter cited as FEDERAL INCOME TAXATION]. Under this analysis, a wife's status entitles her to support and the maintenance of a standard of living commensurate with her husband's station in life. The economic value of these benefits is not subject to taxation while the relationship continues, nor are the wife's

nical analysis asserts that the wife's basis in her marital rights is equal to the fair market value of those rights.[70] Basis is created because the wife's marital rights, representing an interest in her husband's property, are received in the form of nontaxable compensation for her status as wife and/or for the services she renders as part of that position.

A related approach suggests that the wife does not realize any economic gain on the transaction. In a sense, what the wife receives is the equivalent of the current value of her future support rights plus whatever additional interest she possesses in her husband's property. In other words, the wife gives sufficient consideration for the transfer of property.[71] The cash or fair market value of other property received by the wife is deemed to equal the value of the rights she gives up.[72] This results in no economic gain taxable as income to her.[73]

Whatever the theoretical justification, the result seems correct from a policy perspective. Certainly the wife enjoys no overall economic gain on the release of marital rights for cash or property. As the Court indicated in *Gould*, the wife really only receives the interest in her husband's estate to which she is equitably entitled.[74] The tax system recognizes that she merely severs that which she already owns from the husband's estate. Section 71 may be applicable, however, since a spouse who accepts periodic payment, or a fixed sum payable over more than ten years in satisfaction of marital rights, bears the full tax burden on those payments.[75] Alternatively, a lump sum transfer of cash has the effect of dividing the tax burden between payor and recipient, at least where the obligation is satisfied with cash existing in the marital community at the time of divorce.[76] On the other hand, where support or other marital obligations are satisfied with the installment payment of the principal sum over a period of ten years or

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marital rights marketable in the sense that she could realize an economic benefit on disposition. Since these economic benefits are not taxable during marriage, cash or property received by the wife in exchange for these benefits is likewise not subject to income taxation. The payment is, instead, a nontaxable receipt of property as compensation for loss of status.

70. The value of this nontaxable income is the wife's cost for the rights she attains by virtue of marital status. This cost is her basis in those marital rights, the value of which always equals cost. *See* Barton, *supra* note 68, at 438. The realization of cash or other property in exchange for those rights is offset by the wife's basis, resulting in no taxable gain. I.R.C. § 1001(a) (1976).

71. Glickfield, Rabow & Schwartz, *Federal Income Tax Consequences of Marital Property Settlements*, 26 S. CAL. TAX INST. 307, 310-11 (1974).

72. United States v. Davis, 370 U.S. 65, 72 (1962).

73. The approach of the Court in *Gould* is similar. The Court found that alimony is not income to the wife but rather her share "of the husband's estate to which the wife is equitably entitled." 245 U.S. at 153. The wife receives property from the husband representing only that to which she is already entitled. This view of the wife's rights, however, is inconsistent with the Supreme Court's later conclusion in *Davis* that the wife has no property interest in the husband's estate that even remotely reaches the dignity of co-ownership. 370 U.S. at 70.

74. 245 U.S. at 153.

75. I.R.C. § 71(a) (1976).

76. This assumes that the married couple filed a joint return. Cash in the hands of the marital community probably would have been accounted for on that joint return and the tax paid by the marital community. *See id.* § 6013(d)(3); *supra* note 3.

less, the burden of taxation falls upon the payor.[77]

The payor also bears the tax burden where appreciated property is used to satisfy a marital obligation. The United States Supreme Court held in *Davis* that the transfer of appreciated stock in exchange for a wife's release of her inchoate marital rights is a taxable event.[78] Notwithstanding its earlier description of alimony as "a portion of the husband's estate to which the wife is equitably entitled,"[79] the *Davis* Court concluded that the wife's inchoate marital rights under Delaware law placed a burden only on the husband's property rather than creating a co-ownership interest.[80] The wife's marital rights represented a personal liability of the husband, which he satisfied with a transfer of appreciated property.[81] The amount realized by the husband on this transfer equalled the fair market value of the property received by the wife. The husband realized his wife's release of her claim against him, her marital rights.[82] The *Davis* opinion concluded that the fair market value of these marital rights was equivalent to the value given up in exchange for them.[83] Thus, the fair market value of the stock transferred to the wife measured the husband's amount realized on the exchange of that stock. The effect is to tax the transferror husband on pre-transfer appreciation, while the wife receives the property without tax[84] and with a basis equal to fair market value.[85]

The regime resulting from *Davis* suffers from the same difficulty that Congress sought to prevent with sections 71 and 215.[86] As with alimony payments under *Gould*, the transferee wife receives the property tax free.[87] Since her basis is stepped up to a fair market value,[88] she suffers no tax burden on the receipt of that value or on disposition. The transferror, however, not only loses the property, but receives nothing of marketable value in exchange, and is additionally burdened with a tax on appreciation. An example of the hardship caused by this regime is easily constructed. As part of a divorce settlement, a couple often agrees that their only major asset, the appreciated family residence, is to be transferred to the wife in partial or full satisfaction of her claims against the husband.

77. The payor will, in most cases, satisfy his obligation out of current income on which tax is paid. The payor does not obtain a deduction under § 215 where the alimony payments are not taxable to the recipient.

78. 370 U.S. at 70.

79. *Gould*, 245 U.S. at 153.

80. 370 U.S. at 70.

81. *Id.* at 70, 72.

82. *Id.* at 72.

83. *Id.* This conclusion was based on the Court's view that the property division was the result of arm's length bargaining. *Id.* This notion is soundly criticized in Stern & Sellers, *Property Settlements Upon Divorce: Yours, Mine, and the Commissioner's*, 48 UMKC L. REV. 293, 319-22 (1980).

84. 370 U.S. at 73 n.7; Rev. Rul. 67-221, 1967-2 C.B. 63.

85. 370 U.S. at 73.

86. *See supra* notes 10-57 and accompanying text; *see also* Deutsch, *New Approach to the Transfer of Appreciated Property Pursuant to Divorce*, 25 CATH. U.L. REV. 616, 632 (1976) (supporting revision of state statutes governing jointly acquired property).

87. Rev. Rul. 67-221, 1967-2 C.B. 63.

88. *Davis*, 370 U.S. at 73.

Under *Davis* the husband in this situation is taxed on the appreciation in the residence, but may not have an immediate source of cash with which to pay the tax.[89] The husband might escape recognition of gain under section 1034, but only if he has the resources to purchase a new principal residence within two years.[90] The wife receives the residence tax free with a stepped-up basis.

In spite of its differing tax treatment, the *Davis* exchange is similar to periodic payments. In the exchange of appreciated property for marital rights there is a transfer of economic benefit that has not been subject to taxation prior to the transfer. In the case of alimony a transfer of periodic payments occurs out of current earnings that have not been taxed to the transferor. In the latter case, however, the parties are allowed to transfer the tax cost of the economic benefit to the recipient,[91] while in the former the tax burden falls on the transferor.[92] One possible policy justification for this disparate treatment is that in the case of periodic payments, the taxable economic accretion arises from post-divorce earnings of the transferor rather than pre-divorce appreciation on the transferred property. This distinction is an empty one, however, since in both cases the recipient spouse receives the economic benefit of the untaxed gain. Equity suggests that the marital community, composed of both husband and wife equally, should share the tax burden of appreciation occurring during marriage. Alternatively, the tax burden may fall on the recipient at the time he or she realizes the economic benefit from disposition of property received in exchange for marital rights.[93]

The approach taken in *Davis* has no policy justification. The opinion reaches the inequitable result prevented by sections 71 and 215 and imposes the tax burden of appreciation on the party who loses the property.[94] As long as the Treasury Department can tax the economic gain inherent in appreciated property in the year the gain is realized by conversion into money or other property,[95] the type of income splitting provided by sections 71 and 215 should be available on a transfer of appreciated property in satisfaction of marital rights. Under section 71 the recipient of periodic payments is taxed on such income in the year it is received. The same

89. *See* Alcott, *Selected Tax Problems in Matrimonial Disputes and Settlements*, 37 INST. ON FED. TAX'N § 33.04[1], at 33-10 (1979); DuCanto, *Federal Tax Law: Where You Divorce Does Make a Difference*, 9 LOY. U. CHI. L.J. 397, 399-400 (1978).

90. I.R.C. § 1034(a) (Supp. V 1981) provides that no gain will be recognized on disposition of the taxpayer's principal residence as long as the taxpayer purchases and uses a new residence within a period beginning two years before the date of sale of the old residence and ending two years after the date of sale. Gain is recognized to the extent that the "adjusted sales price" of the old residence exceeds the cost of purchasing the new residence. *Id.*

91. *Id.* §§ 71, 215 (1976).

92. *See supra* notes 77-85 and accompanying text.

93. This treatment is similar to that under § 71.

94. Deutsch, *supra* note 86; DuCanto, *supra* note 89; Stern & Sellers, *supra* note 83, at 318.

95. Gain or loss will be taxed on final disposition of the property by the recipient spouse as long as appropriate basis provisions are adopted to defer the realization and recognition of gain or loss until such disposition. *See infra* note 307 and accompanying text.

policy would be served by deferring recognition of gain on appreciated property exchanged for marital rights until the year the property is converted into cash or other property by the recipient, rather than taxing the transferor at the time of divorce.

Sections 71 and 215 allow parties to a divorce to negotiate the tax impact of their arrangement with respect to periodic payments. The tax cost of a transfer of property in lieu of periodic payments should also be negotiable. Tax neutrality and equity might be better served by allowing the parties to a divorce to allocate their tax burden with respect to transfers of appreciated property along with the property itself as they may with respect to periodic payments. The Code could allow the parties flexibility either to divide the tax cost of appreciation between the parties or, alternatively, to shift the tax cost to the party who ultimately enjoys the economic benefit of the property.

IV. Divisions of Property Held in a Form of Joint Ownership

No tax is imposed in the third category of wealth transfer at divorce. The division of co-owned property is not considered a taxable event. The burden of taxation for pre-divorce appreciation generally falls on the person retaining the property.[96] Unfortunately, identifying co-owned marital property is not always an easy task. In *Davis* the taxpayer argued that his marital settlement was a nontaxable division of jointly owned property. The Court rejected the argument, concluding that under Delaware law the wife's inchoate rights in her husband's property "do not even remotely reach the dignity of co-ownership."[97] The Court did, however, give implied approval to the longstanding administrative rule that a division of co-owned property on divorce is not a taxable event.[98] Although some uncertainty about this principle remained immediately following *Davis*, the controversy was settled when the Internal Revenue Service accepted the principle that co-owned property may be divided on divorce without current taxation, but added that an unequal division of co-owned property is taxable in part.[99] The Service ruled that property is co-owned where (1) title is taken jointly under state property law, (2) the state is a community property law state, or (3) state property law is found to be similar to community property law, creating a species of common ownership.[100]

Co-ownership is clear only in the eight community property states expressly identified by state law.[101] In these states each spouse is considered

96. Under current law the recipient of property in a nontaxable division of co-owned marital property retains the marital community, or co-owners', basis in the property. Carrieres v. Commissioner, 64 T.C. 959, 964 (1975), *acq.* 1976-2 C.B. 1, *aff'd per curiam*, 552 F.2d 1350 (9th Cir. 1977).

97. United States v. Davis, 370 U.S. 65, 70 (1962).

98. *Id.* at 69.

99. Rev. Rul. 74-347, 1974-2 C.B. 26. For a detailed discussion of the ruling, see *infra* notes 252-62 and accompanying text.

100. Rev. Rul. 74-347, 1974-2 C.B. 26, 27.

101. *See* ARIZ. REV. STAT. ANN. §§ 25-211 to -217 (1976); CAL. CIV. CODE §§ 5100-5128 (West 1983); IDAHO CODE § 32-906 (Supp. 1983); LA. REV. STAT. ANN. § 9:2801 (West

to own either one-half of each asset or an undivided one-half interest in the whole.[102] Co-ownership in the other two categories is not so easily ascertained. Neither joint title under state property law, nor even sole title in the name of the recipient spouse, guarantees shelter from gain under *Davis*.[103] The third category of co-ownership, property held in a species of common ownership, is the most difficult in terms of qualification. Although several state property schemes seem to bear sufficient similarity to common ownership to qualify under this classification,[104] only three, the laws of Florida, Colorado, and Oklahoma have been so recognized.[105]

1983); NEV. REV. STAT. §§ 123.220-.250 (1981); N.M. STAT. ANN. 1953, §§ 40-3-2 to -17 (1983); TEX. FAM. CODE ANN. §§ 5.01-.87 (Vernon 1975 & Supp. 1982-1983); WASH. REV. CODE ANN. §§ 26.16.030-.050 (Supp. 1983-1984). Of course, the parties in any of these jurisdictions may dispute the title to a specific asset as community property versus a sole ownership interest in one spouse.

102. The nature of an individual spouse's ownership interest is unclear. In California, for example, a spouse is considered to own a one-half interest in each asset for purposes of probate and death-time dispositions, *see* Gantner v. Johnson, 274 Cal. App. 2d 869, 876, 79 Cal. Rptr. 381, 386 (1969), while the aggregate theory treating each spouse as owning an undivided one-half interest in the whole is used in divorce cases, *see* Phillipson v. Board of Admin., 3 Cal. 3d 32, 473 P.2d 765, 772-73 (1970). The nature of a spouse's interest in the other community property states also varies. *See generally* W. REPPY & W. DEFUNIAK, COMMUNITY PROPERTY IN THE UNITED STATES 444-45, 464-65 (1975).

103. The Service has ruled that an equal division of jointly owned property will not be treated as a taxable event. Rev. Rul. 81-292, 1981-2 C.B. 158, 159. The existence of joint title, however, does not guarantee tax-free treatment. In Forbes v. United States, 472 F. Supp. 840 (D. Mass. 1979), the district court held that property held by a Massachusetts couple as tenants in the entirety was not co-owned property. *Id.* at 842. The court found that the wife's interest was no greater than the inchoate interest of the wife in *Davis*. *Id.* Similarly, sole title in the recipient prior to divorce does not always free the other spouse from taxation under *Davis*. In Swaim v. Commissioner, 50 T.C. 302 (1968), *aff'd*, 417 F.2d 353 (6th Cir. 1969), the Tax Court held that disposition of an installment note as part of a divorce settlement was taxable to the husband under I.R.C. § 453(d) (current version at § 453B (Supp. V 1981)), notwithstanding the fact that title to the note was solely in the wife's name prior to divorce. 50 T.C. at 305. The note was received on the sale of property held by husband and wife as joint tenants. They had each taken separate notes for their individual share of the sales proceeds. In the state divorce proceeding the trial court held under state law that since the notes originated in property acquired with the husband's funds, the wife was required to restore the note to him. Ultimately, however, the trial court allowed the wife to keep the note. The Tax Court concluded that the note had been transferred to the wife in a transaction taxable under *Davis*. *Id.*; *see also* Cook v. Commissioner, 80 T.C. 512 (1983). In *Cook* the husband was allowed to return appreciated property to his wife without tax. The husband had obtained the property in a completed gift from his wife. Title was in the husband alone. The Tax Court relied in large part upon the testimony of the state divorce referee that he ordered the husband to return the stock and other property because there was "more or less a quasi-ownership in [the wife]" and the property was considered a part of the wife's family estate. 80 T.C. at 527. The Tax Court thus concluded that the stock transfer was not a taxable division of property. *Id.* at 528.

104. Commentators have identified several state provisions, which if properly interpreted by state courts, could give rise to the "species of common ownership" described in Rev. Rul. 74-347, 1974-2 C.B. 26. *See* Sterns & Sellers, *supra* note 83, at 302 n.50; Note, *Should Federal Income Tax Consequences of Divorce Depend on State Property Law?*, 49 S. CAL. L. REV. 1401, 1419-23 (1976).

105. *See* Bosch v. United States, 590 F.2d 165 (5th Cir. 1979) (Florida), *cert. denied*, 444 U.S. 1044 (1980); Imel v. United States, 523 F.2d 853 (10th Cir. 1975) (Colorado); Collins v. Commissioner, 412 F.2d 211 (10th Cir. 1969) (Oklahoma).

A. Examination of the Species of Common Ownership

Consideration of the species of common ownership begins with *Pulliam v. Commissioner*,[106] where the Tenth Circuit Court of Appeals held that a voluntary transfer of appreciated property in a Colorado divorce generated taxable gain to the husband under *Davis*.[107] The Colorado statute permitted the divorce court to make reasonable provision for payment of alimony and maintenance of the wife, and directed the divorce court to decree a division of property. In dividing property the divorce court considered such factors as the couple's financial condition, the husband's duty of support, the extent of property brought into the marriage by the wife, and the husband's earning capacity. The husband attempted to distinguish *Davis*, which was based on voluntary transfer, from the court-ordered transfer imposed in *Pulliam*. The court held that under Colorado law the husband had a duty to make provision for his wife's support, and noted that the wife's rights during marriage did not vest in any ownership in the husband's property.[108] The court thus upheld the Commissioner's assertion that the transfer of appreciated property to the wife was a taxable event.[109]

In *Collins v. Commissioner*[110] the Tenth Circuit followed its *Pulliam* holding to conclude that under Oklahoma law a wife's rights do not include a vested interest in marital property sufficient to avoid recognition of gain to the husband under *Davis*.[111] Like the Colorado statute in *Pulliam*, the Oklahoma statute required the divorce court to divide property acquired by the parties jointly during marriage in a just and reasonable manner.[112] The Collinses had entered into a voluntary property settlement that was approved by the Oklahoma divorce court. The taxpayer argued that under Oklahoma law his wife had a vested interest in their marital property and that the division was therefore a nontaxable division of co-owned property. The Tenth Circuit surveyed Oklahoma case law holding that jointly acquired property is regarded as held in a species of common ownership.[113] The state decisions also established that marital property was to be divided independent of provisions for alimony and that an Oklahoma divorce court should consider the manner in which the property was acquired and the actions of both parties in accumulating and retaining the estate. The court of appeals noted, however, that the Oklahoma courts had held that one spouse holds no specific vested interest in any specific property owned by the other spouse.[114]

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106. 329 F.2d 97 (10th Cir.), *cert. denied*, 379 U.S. 836 (1964).
107. 329 F.2d at 99.
108. *Id.* at 97.
109. *Id.* at 99.
110. 388 F.2d 353 (10th Cir.), *vacated and remanded*, 393 U.S. 215 (1968), *rev'd*, 412 F.2d 211 (10th Cir. 1969).
111. 388 F.2d at 355.
112. OKLA. STAT. ANN. tit. 12, § 1278 (West 1961) (current version at OKLA. STAT. ANN. tit. 12, § 1278 (West Supp. 1982-1983)); 388 F.2d at 354 n.2.
113. 388 F.2d at 355-56.
114. *Id.* at 356-57.

The Tenth Circuit compared the Oklahoma statute with the Colorado provision considered in *Pulliam* and found that the Colorado statute, like the Oklahoma provision, considered the property division separate from alimony and that both were awarded on the theory that the wife should have a share of the property upon divorce.[115] The court concluded that there was no distinction between the two state provisions to justify a different result.[116] The Oklahoma statute therefore did not include traditional rights of ownership, and the division was taxable under *Davis*.[117]

Subsequent to the Tenth Circuit's initial *Collins* decision, the Oklahoma Supreme Court held that the property division in *Collins* was not taxable under the state tax code.[118] The Oklahoma court interpreted the state statute as giving the wife an interest similar in concept to community property. The property therefore was held in a species of common ownership.[119] Following this decision, the United States Supreme Court granted certiorari in *Collins* and remanded the case to the Tenth Circuit for consideration in light of the state supreme court decision.[120] On remand the Tenth Circuit reiterated its statement that the question of co-ownership under *Davis* depends upon state law and held that the highest state court's interpretation of the marital property interest controlled in this setting.[121] The Tenth Circuit, reversing its initial decision, concluded that the transfer was a nontaxable division of property between co-owners and rejected the Commissioner's argument that *Davis* creates a federal standard for co-ownership.[122]

In *Wiles v. Commissioner*[123] the Tenth Circuit Court of Appeals held that a Kansas statute did not create a co-ownership interest similar to the Oklahoma provision.[124] In *Wiles* the taxpayers had negotiated a property settlement agreement under which neither spouse claimed alimony, and which provided for an equal division of property. The husband and wife in *Wiles* managed to create a fair and equitable property division, which the Commissioner disrupted by imposing the tax burden of the division on the husband. Like the Oklahoma provision, the Kansas statute requires the divorce court to marshal all of the couple's property, regardless of ownership or acquisition, and divide it in a just and reasonable manner.[125] The divorce court is further directed to consider the source of the property, the contribution of the parties, their earning capacity, fault, needs, ages,

115. *Id.* at 357.
116. *Id.*
117. *Id.*
118. Collins v. Oklahoma Tax Comm'n, 446 P.2d 290 (Okla. 1968).
119. *Id.* at 295.
120. 393 U.S. 215 (1968).
121. Collins v. Commissioner, 412 F.2d 211, 212 (10th Cir. 1969).
122. *Id.* at 212.
123. 499 F.2d 255 (10th Cir.), *cert. denied*, 419 U.S. 996 (1974).
124. 499 F.2d at 259. In the initial *Collins* opinion the court noted that the Oklahoma and Kansas statutes were similar. 388 F.2d at 353 n.9. The similarities did not, however, lead to a similar tax treatment.
125. KAN. STAT. ANN. § 60-1610 (1973) (current version at KAN. STAT. ANN. § 60-1610 (Supp. 1982)).

and length of marriage. As in Oklahoma and Colorado, the wife's property interest is independent of any right to alimony or support.[126] In applying the Kansas statute, the Tax Court had noted that the Kansas Supreme Court compared the Kansas marital relationship to a partnership, the termination of which was to be accompanied by a property division regardless of fault.[127] The Tax Court also found, however, that the Kansas statute could operate to divest a husband of his separate property, and further, that nearly all of the securities transferred to the wife in the property settlement had been brought into the marriage by the husband.[128] The Tax Court held that, absent a clear state court decision as in *Collins*, it was required to follow its first decision in *Collins*[129] treating the property division as a taxable event.[130]

On appeal the Tenth Circuit concluded that the Kansas wife's right to a just and equitable share of the marital property was not a co-ownership interest.[131] The court noted that the wife's interest in her husband's property vested only upon the husband's death, and then only if the wife survived.[132] The Tenth Circuit also recognized that the wife may expect to receive a share of her husband's property on divorce.[133] It pointed out, however, that the property division was within the discretion of the trial court, and opined that the trial court's consideration of the source of the property, the parties' contributions, earning capacity, and fault, as well as other factors required by state law, was inconsistent with the idea of co-owned property.[134] "If the wife were a co-owner in Kansas, her interest in the property to be divided would be based on more than a right to a 'just and equitable' share therein."[135] Notwithstanding its second *Collins* decision,[136] the Tenth Circuit apparently believes that co-ownership requires a definite interest vested in the wife during marriage. An interest that vests only on the filing of a divorce action is not sufficient.[137] The property interest of an Oklahoma wife was modeled on the Kansas statute and is not materially different from the Kansas interest described by the court in *Wiles*.[138] The Tenth Circuit also noted the United States District Court

126. 499 F.2d at 257.

127. 60 T.C. 56, 61 (1973), *acq.* 1973-2 C.B. 4, *aff'd*, 499 F.2d 255 (10th Cir.), *cert. denied*, 419 U.S. 996 (1974).

128. 60 T.C. at 63.

129. Collins v. Commissioner, 46 T.C. 461 (1966), *aff'd*, 388 F.2d 353 (10th Cir.), *vacated and remanded*, 393 U.S. 215 (1968), *rev'd*, 412 F.2d 211 (10th Cir. 1969).

130. 60 T.C. at 63.

131. 499 F.2d at 258.

132. *Id.* at 257.

133. *Id.*

134. *Id.* at 257-58.

135. *Id.* at 258.

136. Collins v. Commissioner, 412 F.2d 211 (10th Cir. 1969).

137. This is the reasoning adopted by the Tenth Circuit in its initial *Collins* decision. *See* 388 F.2d at 356-57.

138. The Oklahoma wife had no vested interest prior to divorce and the division of property was subject to an exercise of the trial court's discretion. Collins v. Oklahoma Tax Comm'n, 446 P.2d 290, 295 (Okla. 1968); *see* Cady v. Cady, 224 Kan. 339, 581 P.2d 358, 363 (1978) (holding that Kansas statute creates species of common ownership in accord with

decision in *Imel v. United States*,[139] where on certification the Colorado Supreme Court held that the Colorado statute[140] recognized a species of common ownership of the marital estate by the wife resembling a division of property between co-owners.[141] The *Wiles* court rejected both the Colorado and Oklahoma decisions, saying "[t]hey are noted in recognition of the disparities which exist in the application of federal tax statutes to transactions occurring in the states which compose the Tenth Circuit."[142]

Soon after *Wiles* the Tenth Circuit reexamined the Colorado statute. In *Hayutin v. Commissioner*[143] the court followed *Pulliam* and concluded that Colorado law did not create a co-ownership interest in the wife in spite of the Colorado Supreme Court's holding otherwise in its interpretation of the statute in connection with *Imel*. The *Hayutin* court considered whether periodic payments to the wife were in satisfaction of a marital obligation of the husband and therefore taxable to the wife under section 71, or, as asserted by the wife, a nontaxable property settlement. The court decided the question against the wife, concluding that under Colorado law the wife had no vested interest in the husband's property. The payments could not, therefore, have been a property settlement.[144] The Tenth Circuit stated that the Colorado husband's property is basically free from any vested interest of the wife, except for her inchoate rights, which vest upon the filing of the divorce action.[145] These rights, said the court, are contingent upon divorce, are in an undetermined amount of property, and are analogous to those of a wife who can establish a resulting trust.[146] The rights could not be exercised by the wife during marriage. The court also pointed out that the statute directing a just and equitable division of the marital property was discretionary with the trial court.[147] Echoing the language of its opinions in the first *Collins* decision and *Wiles*, the Tenth Circuit concluded that "[t]hese factors are inconsistent with the idea of co-owned property. A co-owner's rights in property to be divided would depend not upon marital factors and their right to a 'just', 'equitable', or 'fair' share . . . , but would depend upon actual ownership rights."[148] The court thus found that "although the payments in question might be characterized by Colorado courts as a property settlement they are in fact pay-

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cases decided by Oklahoma courts). For a comparison of the Oklahoma and Kansas statutes, see Graham, *Taxation on Transfer of Capital Assets at Divorce—A Proposal for Reform*, 19 WILLAMETTE L.J. 229, 242-43 (1983). The Tenth Circuit described its second *Collins* decision and the Oklahoma statute as "troublesome," but indicated that the Oklahoma law was in a state of flux. *Wiles*, 499 F.2d at 258.

139. 375 F. Supp. 1102 (D. Colo. 1974), *aff'd*, 523 F.2d 853 (10th Cir. 1975).

140. COLO. REV. STAT. §§ 46-1-5, -13 (1963) (current version at COLO. REV. STAT. §§ 14-10-105, -113 (1973 & Supp. 1982)).

141. *In re* Questions Submitted by United States Dist. Court for Dist. of Colo., 517 P.2d 1331 (Colo. 1974).

142. 499 F.2d at 259.

143. 508 F.2d 462 (10th Cir. 1975).

144. *Id.* at 469.

145. *Id.*

146. *Id.*

147. *Id.*

148. *Id.*

ments in satisfaction of a marital obligation and not part of a division of marital property."[149]

Notwithstanding the fine distinctions between the second *Collins* decision and *Wiles* that were drawn in *Hayutin*, the Tenth Circuit changed its view when faced with the *Imel* case itself.[150] As in its second *Collins* opinion, the Tenth Circuit rejected the government's argument that *Davis* established a federal standard as to the nature of the wife's pretransfer rights in marital property.[151] In addition the court stated that *Davis* did not define the time at which the interest of the wife had to vest.[152] Finally, the court noted that both the Oklahoma and Colorado state courts had held that vesting occurred at the time of the filing of the divorce suit.[153] This latter comment undermines the Tenth Circuit's reasoning in both *Wiles* and *Hayutin*, where it focused on the absence of a vested property interest during marriage.[154]

The *Imel* decision undercuts a second major premise of *Wiles*. The Tenth Circuit had indicated in *Wiles* that state law allowing a discretionary property division by the trial court based on various factors such as the contribution of each party and fault was inconsistent with the idea of co-owned property.[155] The Colorado statute at issue in *Imel* directed the trial court to divide marital property "in such proportions as may be fair and equitable."[156] The Colorado statute required consideration of factors sim-

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149. *Id.* One commentator has observed:

> The error in the *Hayutin* court's application of *Davis* to the property/support distinction is that it equates co-ownership of property with a marital right in that property. The issue in a property/support determination is not whether the property is co-owned, but whether the payments are made in consideration for the relinquishment of some right in currently held property as opposed to a right to a future income stream.

Note, *supra* note 19, at 949. A marital right to property may be tantamount to an ownership interest in property. In Bosch v. United States, 590 F.2d 165 (1979), *cert. denied*, 444 U.S. 1044 (1980), holding that a Florida wife's "special equity" is a property interest subject to tax free division between co-owners, the court accepted the parties' agreement that "the question whether this decree was a division of property interests between the parties or was an award in lieu of alimony is to be resolved by reference to state law." 590 F.2d at 167.

150. Imel v. United States, 523 F.2d 853 (10th Cir. 1975). The Colorado Supreme Court has stated that a Colorado wife has a species of common ownership. *In re* Questions Submitted by United States Dist. Court for Dist. of Colo., 517 P.2d 1331 (Colo. 1974).

151. 523 F.2d at 856.

152. *Id.*

153. *Id.*

154. Although the Tenth Circuit did not expressly say in *Wiles* that the wife's interest under Kansas law vested upon filing the divorce action, the court's opinion is based in part upon its conclusion that the wife had no vested interest in property during marriage. The court said:

> Just as the wife's inchoate rights vest upon her husband's death, the filing of a divorce suit confers additional rights on the wife. The state divorce laws compel the courts to marshal all of the parties' property, regardless of ownership or acquisition, and to divide it in a just and reasonable manner.

499 F.2d at 257. The court added that "[t]he Davis test depends on the transferee's rights in the property during marriage." *Id.* at 258.

155. *Id.* at 257-58.

156. 375 F. Supp. at 1113 (quoting COLO REV. STAT. § 46-1-5 (1963)). The current version of the Colorado statute is at COLO. REV. STAT. § 14-10-105 (Supp. 1982).

ilar to those enumerated in the Kansas statute.[157] The Tenth Circuit failed to explain how these factors might be inconsistent with joint ownership in Kansas, but consistent with joint ownership in Colorado.

The *Imel* court distinguished its *Hayutin* decision, saying that the question of the wife's tax liability in the latter case depended upon an interpretation of sections 71 and 215, and that questions of capital gain under section 1001 were not at issue there.[158] The *Imel* court thus concluded that its discussion of these issues in *Hayutin* was neither determinative nor essential to the decision in that case.[159] The most casual reading of *Hayutin*, however, indicates that the decision relies primarily upon the absence of a property interest in the wife for its conclusion that payments to her constituted support or maintenance.[160] The *Imel* court ultimately admitted that the essential distinction between its opinions in the second *Collins* decision and *Imel*, and its other opinions finding a lack of co-ownership in the wife, was the existence of a state supreme court opinion in the very case being litigated.[161] Although this factor is of paramount importance in the Tenth Circuit, and indeed is the only factor that really distinguishes the cases, the court has yet to describe a sound justification for the difference between the tax treatment afforded property divisions in Colorado and Oklahoma and the tax treatment of Kansas property divisions.[162] All three states have nearly identical statutes, but Kansas lacks the appropriate state court decision.[163] This reliance on the existence of a state court interpretation precisely on point and involving the very parties before the court in the tax matter is both bad policy and misapplication of the role of state law and the federal tax statute.[164]

State law defines the nature of the legal relationships of a particular taxpayer. Thus the federal courts have appropriately considered such matters as the time of vesting and other factors utilized by state courts in dividing marital property to define the nature of a particular property interest under state law principles. In *Bosch v. United States*,[165] for example, the Fifth Circuit Court of Appeals held that a Florida wife's "special equity" interest in property in the husband's name is a co-ownership interest for purposes of *United States v. Davis*.[166] The court based its holding on the

157. *See* Stern & Sellers, *supra* note 83, at 301.
158. 523 F.2d at 856.
159. *Id.*
160. *Cf.* Mills v. Commissioner, 58 T.C. 608 (1970) (wife's extensive activities in ranching operation during marriage gave her property interest so that payments determined to be property settlement), *aff'd*, 442 F.2d 1149 (10th Cir. 1971).
161. 523 F.2d at 856.
162. *See* Stern & Sellers, *supra* note 83, at 300 n.40 (suggestion that IRS will not treat Kansas marital property divisions as taxable).
163. *But see* Cady v. Cady, 224 Kan. 339, 581 P.2d 358, 363 (1978) (filing of petition for divorce or separate maintenance creates a species of common ownership).
164. Hull, *The New Uniform Divorce Laws: The* Davis *Decision*, 37 INST. ON FED. TAX'N § 36.04, at 36-9 to -10 (1979); Steines, *supra* note 20, at 236; Comment, *The Federal Income Tax Consequences of Property Settlements in Common Law States and Under the Uniform Marriage and Divorce Act: A Proposal*, 29 ME. L. REV. 73, 95-98 (1977).
165. 590 F.2d 165 (5th Cir.), *cert. denied*, 444 U.S. 1044 (1979).
166. 590 F.2d at 168; *see also* Serianni v. Commissioner, 80 T.C. 1090 (1983) (special

conclusion that the wife possessed a vested interest in property before divorce and that the property was not transferred to the wife in lieu of a lump sum alimony payment.[167] State court labels attached to those rights and obligations are meaningless for federal tax purposes, however. Federal tax law is dependent on the legal rights and obligations created by state law, but the federal tax impact of those rights and obligations is a question of federal tax law.[168] Neither the "species of common ownership" label developed by the Oklahoma Supreme Court in *Collins* and adopted by the Colorado Supreme Court in *Imel*, nor the Florida "special equity" label considered in *Bosch*, should have any impact for federal tax purposes.[169] The proper role for state law and state judicial interpretation of that law lies in identifying the rights and obligations of the parties vis-à-vis each other. Thus a federal court is bound by the highest state court's identification and description of the state law property interest.[170] The federal courts must then develop and apply a rule of federal tax law to such state-defined rights and obligations. The question must be, therefore, not whether the highest court in a state defines a spouse's interest as a species of common ownership, but whether under federal law the state-created rights and obligations of the spouse are sufficient to meet a federal standard of co-ownership.[171] The virtually identical property interests in Colorado, Oklahoma, and Kansas should not generate disparate federal tax results solely because of state court labels.

In *Davis* the United States Supreme Court expressed a willingness to tolerate disparate treatment of property divisions in community property and common law jurisdictions.[172] What has evolved, however, is a disparity between common law states with similar statutes in addition to the disparity between community property and common law states. The courts have been willing to tolerate this disparity, but Congress should not. Congress should act as it has in the past[173] to create uniform tax treatment for

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equity interest found by state court constitutes a vested equitable property right that is divisible on divorce without tax).

167. 590 F.2d at 168. This reliance on vesting before divorce is of course inconsistent with the Tenth Circuit's views in its second *Collins* opinion, 412 F.2d at 212, and *Imel*, 523 F.2d at 857, which find a co-ownership interest in the wife whose interest vests only on the filing of the divorce action, but is in accord with the Tenth Circuit opinions in its first *Collins* decision, 388 F.2d at 357-58, and *Wiles*, 499 F.2d at 259, which conclude that the absence of a vested interest during marriage defeats co-ownership.

168. United States v. Mitchell, 403 U.S. 190, 197 (1971); Burnett v. Harmel, 287 U.S. 103, 110 (1932); *see also* Hayutin v. Commissioner, 508 F.2d 462, 468 (10th Cir. 1974) (state supreme court's characterization of transfer not controlling for tax purposes).

169. As in *Imel*, the state court may have no interest in the label attached to marital property. Yet the Tenth Circuit has allowed the state court to define the federal tax issue. The ad hoc decision-making so evident in the Tenth Circuit results from that court's reliance solely upon state judicial decisions.

170. Commissioner v. Estate of Bosch, 387 U.S. 456, 465 (1967).

171. For example, a federal court might conclude that a federal standard requires a vested interest during marriage. The federal court would look to state law to ascertain whether a spouse's interest is vested. If not, there would be no co-ownership, even if the highest state court labelled the property interest as a species of common ownership.

172. 370 U.S. at 69-70.

173. The income splitting device of the joint return was adopted in 1948 to "produce

similar transactions in different states. In so doing, Congress should depart from the Supreme Court's technical analysis in *Davis* and look to the economic nature of the relationship being terminated. Such an inquiry will provide sound justification for a nonrecognition rule in marital property divisions.

Before divorce in a common law state each spouse has a bundle of legal rights. The husband owns property and the wife possesses inchoate and/or vested rights in that property.[174] Each of these interests is valuable and exchangeable for either money or property according to the *Davis* court.[175] Perhaps the best view of the property division, even if fictional, is that after divorce each spouse possesses a property interest equivalent to what he or she owned before divorce, but a division of those interests has occurred to facilitate termination of the marital relation. A tax free exchange of such interests is tolerated where the property exchanged is held in some form of legal joint ownership such as community property or where state law is interpreted to create some sort of species of common ownership. On the other hand, a taxable exchange occurs where the form of legal ownership is inchoate or not completely vested at some relevant point in time.

In a divorce proceeding the trial court determines the portion of marital property each spouse is entitled to receive as his or her separate interest. One party may be entitled to support from the other, and there may be some division of property. The only distinction to be drawn is between the recurring payments of support from current income and an in-kind division of property interests both vested and inchoate.[176] Common law and community property jurisdictions do not differ in this respect. They differ only as to the rules for allocating property interests and the legal nature of the relationship. In many common law and some community property jurisdictions trial courts are required to make just and equitable divisions of

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substantial geographical equalization in the impact of the tax on individual incomes." S. REP. NO. 1013 (pt. 1), 80th Cong., 2d Sess. 22 (1948), *reprinted in* 1948 U.S. CODE CONG. SERV. 1163, 1187.

174. Even if the wife possesses no more than a right to future support, she has a chose in action against the husband that may encumber his current property and future earnings. This chose in action, or right to future income, is convertible into current property on an exchange for lump sum alimony. *See* H. CLARK, *supra* note 45, at 447. The common law dower right of a wife has also been described as an encumbrance on the husband's property. 25 AM. JUR. 2D *Dower* § 6 (1966). Each of these interests in, or restrictions on, property may be exchanged or given up for a current transfer of property. Legally, and perhaps philosophically, the common law wife's relinquishment of marital rights may be different from the community property wife's exchange of a vested interest in community property retained by the husband for an undivided interest in other community property, but economically the transactions may be identical. This is particularly true when comparing a community property state where the divorce court is directed to divide property in an equitable fashion, with a common law state where the same discretion is given to the divorce court. Equitable division of community property is provided for in Arizona, ARIZ. REV. STAT. ANN. § 25-318A (Supp. 1983-1984); Nevada, NEV. REV. STAT. § 125.150(1)(b) (1981); Texas, TEX. FAM. CODE ANN. § 3.63 (Vernon Supp. 1982-1983); and Washington, WASH. REV. CODE ANN. § 26.09.080 (Supp. 1983-1984).

175. 370 U.S. at 72.

176. *See* Steines, *supra* note 20, at 236-37.

marital property.[177] In a common law system property can be received as lump sum alimony in exchange for the current right to future support and a release of other rights.[178] In a community property system property can be received in exchange for the current interest in property retained by the other spouse. One spouse's possession of sufficient property may relieve the other spouse of an obligation to pay support. In either system each spouse retains the equivalent of his or her pre-divorce property interest and in exchange releases the interest of the other party. Regardless of labels, or the standards for division and determination of proportion, this exchange and release occurs. An exchange of property or property-like interests thus takes place in a common law state divorce just as it does in a community property state divorce. Sound tax policy would not require recognition of gain in one situation while allowing nonrecognition in the other. Recognition of gain or loss in both should stand or fall on the same policy analysis. In that context *Davis* provides no policy reason for taxing marital property divisions other than its adherence to a technical analysis of amount realized.

The policy inquiry should recognize that marital property divisions do not increase the wealth of either party. After separation each party theoretically retains the equivalent of the state law property interest that he or she possessed before the separation. Although the technical analysis of *Davis* finds a realization of gain, there is no true economic benefit to the spouse transferring appreciated property. Indeed, if we recognize that the transferor receives nothing of exchangeable value for the appreciated property, the transferor spouse suffers a net economic loss. The logic that makes it inappropriate to tax the payor of alimony on funds used to make the payment also makes it inappropriate to tax the transferor of appreciated property in exchange for a release of the transferee's marital rights.

Finally, the only loss to the Treasury is deferral of recognition. As with nontaxable divisions of community property, gain or loss will be recognized on final disposition of the property. Using current basis rules for nontaxable community property divisions places the burden of taxation for pre-divorce appreciation on the recipient spouse at the time of final disposition.[179]

Some commentators have suggested treating marriage as a partnership.[180] Property acquired during marriage would be treated as partnership property, divisible on divorce without taxation. However the result is justified, a uniform nonrecognition rule for marital property division

177. *See supra* note 174.

178. *See* H. CLARK, *supra* note 45, at 447.

179. This burden may be an inequity in itself. A better basis rule would also divide basis among husband and wife in proportion to their interest in the marital property. *See infra* notes 307-32 and accompanying text (discussing basis and its allocation).

180. Stern & Sellers, *supra* note 83, at 325-26; Comment, *supra* note 164, at 91-95; *see also* Hjorth, *Community Property Marital Settlements: The Problem and a Proposal*, 50 WASH. L. REV. 231, 264-75 (1975) (advocating partnership tax treatment for marital divisions of community property).

serves two important goals of taxation, tax neutrality between similar transactions in different states, and the ultimate recognition of gain or loss on the date the gain or loss is realized due to disposition of property.[181]

B. Division of Jointly Owned Property

The nontaxable division of co-owned property is complicated by the difficulty of structuring an equal in-kind division of jointly owned property. The use of separately owned property or a note to equalize property division may trigger a taxable event. In addition, even the simplest in-kind division of joint property raises basis issues making an equal division impossible.[182] Before addressing these problems, it is worthwhile to examine the theory behind nontaxable divisions.

The Board of Tax Appeals first considered the matter in *Commissioner v. Walz*.[183] The Board denied a loss to the estate of the deceased husband on the transfer of depreciated stock to his wife as part of a Texas marital property settlement. Texas was and remains a community property jurisdiction.[184] The Board refused to allow a loss where two or more parties owning a mixed aggregate of assets partitioned the assets.[185] The Board indicated that the wife received only "that which was hers already" and that there had been "no sale or exchange of the property in question."[186]

Conversely, the Tax Court found a taxable exchange of Texas community property in *Commissioner v. Rouse*.[187] The husband in *Rouse* retained all of the community property and transferred cash to the wife. The cash received by the wife was less than the community's cost basis for the assets retained by the husband. On the subsequent sale of his retained community property, the husband claimed the community's basis in the property as his basis for purposes of computing gain rather than the amount paid to his ex-wife for her interest in the property. The Fifth Circuit Court of

181. *See* Steines, *supra* note 20, at 245-46; 19 BULL. A.B.A. SEC. TAX'N No. 4, 63-66 (1966); *infra* notes 239-43 and accompanying text. In the context of a general proposal for taxation of appreciation on death, the Treasury Department recommended to Congress that interspousal transfers, including transfers on divorce, not be taxed. U.S. TREAS. DEPT., 91ST CONG., 1ST SESS., TAX REFORM STUDIES AND PROPOSALS (pt. 3) 340, 343 n.6 (Comm. Print 1969). The Tax Reform Act of 1983, H.R. 4170, 98th Cong., 1st Sess. (1983), would treat property transfers incident to divorce as a gift with the transferor's basis carried over to the transferee. *Id.* § 422.

182. *See infra* notes 307-33 and accompanying text.

183. 32 B.T.A. 718 (1935).

184. *See* TEX. FAM. CODE ANN. § 5.01 (Vernon 1975).

185. 32 B.T.A. at 719.

186. *Id.* at 720. The Board stated that

> In the instant case when the one-half interest of the wife in the community property was set apart to her in the separation agreement, she was only receiving that which was hers already. We think the situation is not affected by the fact that [the stock was] awarded to the wife in the division of property and charged to her at its then fair market value . . . .
>
> Gain or loss on this property thus divided would depend upon its subsequent disposal by the respective parties. Here there has been no sale or exchange of the property in question, but a division of the property.

Id. at 719-20.

187. 6 T.C. 908 (1946), *aff'd*, 159 F.2d 706 (5th Cir. 1947).

Appeals affirmed the Tax Court's holding that the property settlement was a taxable purchase by the husband and sale by the wife, thereby giving the husband a basis in the retained community property equal to the amount paid to the wife.[188]

The Tax Court described the property settlement in *Rouse* as a bargain and sale.[189] "Such property settlements are arm's length transactions, valid in all respects. They result in the transfer of property rights or interests for a consideration, and there is no sufficient reason to distinguish them from any other transactions fundamentally similar."[190] With respect to equal in-kind divisions of community property the Tax Court added:

> [W]here, in exchange for a vested undivided one-half interest in the whole, each party receives a vested interest in the whole of one-half, obviously there would be no resulting taxable gain, and no change in the basis of any of the property by reason of the settlement.[191]

The Board in *Walz* labelled an equal community property settlement a nontaxable partition or division of property.[192] The Tax Court in *Rouse* referred to the nontaxable settlement as an exchange with no resulting taxable gain.[193] Subsequent opinions have also vacillated as to whether the division of community property should be called an exchange or a partition.[194] The authorities are in agreement, however, that an approximately equal division of community property is not subject to taxation. Judge Hall, writing for the Tax Court in *Carrieres v. Commissioner*,[195] put the issue in proper perspective. She recognized that a division of community property represents an exchange subject to the provisions of the Code dealing with the sale, exchange, or disposition of property, but added that "judge-made, well-settled law concerning the division of community property upon a divorce makes exceptions to that general rule. In effect, a nonstatutory nonrecognition rule has been created."[196]

As the *Rouse* decision points out, each party to a community property

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188. 6 T.C. at 911; 159 F.2d at 707.

189. 6 T.C. at 913. The court cited Johnson v. United States, 135 F.2d 125, 130 (9th Cir. 1943). *See infra* notes 208-12 and accompanying text.

190. 6 T.C. at 913.

191. *Id.* at 914.

192. 32 B.T.A. at 720.

193. 6 T.C. at 914.

194. *See* Davidson v. Commissioner, 43 T.C.M. (CCH) 854, 857 (1982); Siewert v. Commissioner, 72 T.C. 326, 332-33 (1979); Harrah v. Commissioner, 70 T.C. 735, 748 (1978); Carson v. Commissioner, 37 T.C.M. (CCH) 818, 820 (1976); Showalter v. Commissioner, 33 T.C.M. (CCH) 192, 194 (1974); Davenport v. Commissioner, 12 T.C.M. (CCH) 856, 857 (1953) (appeal dismissed on stipulation).

195. 64 T.C. 959 (1975), *acq.* 1976-2 C.B. 1, *aff'd per curiam*, 552 F.2d 1350 (9th Cir. 1977).

196. *Id.* at 963; *see also* Carson v. Commissioner, 37 T.C.M. (CCH) 818, 820 (1978) (citing *Carrieres*). Section 1001 of the Code provides that gain or loss on the sale or exchange of property is determined by comparing the amount realized, defined as the amount of money plus the fair market value of property received, with the adjusted basis of the property given up. I.R.C. § 1001(a)-(b) (1976). Section 1001(c) requires that unless otherwise provided in the Code this gain or loss must be recognized. *Id.* § 1001(c). No express provision exists for nonrecognition of gain or loss on the division of community or other jointly held marital property. Judge Hall would fill this statutory void with the "well-set-

division exchanges a one-half interest in the whole of the marital property for separate ownership of the whole of one-half.[197] Stated differently, in exchange for the husband's one-half interest in the community assets she retains, the wife gives up her one-half interest in assets retained by the husband. This is more than a mere partition or division of jointly owned property. Each spouse gives up a one-half interest in some property in exchange for a release of the other party's one-half interest in property that is retained. Since each party owns an undivided one-half interest in the community property to begin with, the retention of that other one-half interest could not be the product of an exchange.

Under a technical application of section 1001 of the Code, the amount realized on this exchange by a spouse is the fair market value of the other spouse's one-half interest in retained assets.[198] Thus, in exchange for the one-half interest in property transferred to the wife, the husband realizes the fair market value of one-half of the joint property he retains. The adjusted basis of property given up by each party in this exchange is one-half of the community basis in the property transferred to the other spouse. Thus, the basis of property given up by the husband is one-half of the community basis in the property retained by the wife. Realized gain or loss equals the difference between these two figures.[199]

One attempt to avoid the exchange nature of community property divisions would focus on the nature of the property interest being divided. An exchange is recognized if under state law each spouse owns an undivided one-half interest in each community asset. In this case there is an exchange of a spouse's interest in each asset for the interest of the other in retained assets. But where each spouse is considered to own an undivided

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tled" judge-made nonrecognition rule. Of course, such a nonrecognition rule is unnecessary if there is merely a partition of jointly held property.

197. *Rouse*, 6 T.C. at 914.

198. I.R.C. § 1001(b) (1976).

199. A simple example will illustrate this proposition. Assume that *H* and *W*, a married couple in a community property state, have two assets, each with a fair market value of $100. Asset *X* has a basis of $20, and asset *Y* has a basis of $50. Under a marital property settlement *H* receives asset *X* and *W* receives asset *Y*. *H* has exchanged his one-half interest in asset *Y* in order to obtain sole ownership of asset *X*. In doing so he has received *W*'s interest in *X* in exchange for his interest in *Y*. *H*'s amount realized on this exchange is the fair market value of *W*'s one-half interest in asset *X*, $50. The other $50 of asset *X* belonged to *H* to begin with. *H* retains his community interest in *X* in addition to receiving *W*'s interest in *X* in the exchange.

The basis of property given up by *H* in the exchange is one-half of the community's basis in asset *Y*, $25, corresponding to *H*'s one-half interest in asset *Y* transferred to *W*. *H* realizes a gain of $25 ($50 - $25), which is not recognized under the judge-made nonrecognition rule. *W* realizes a gain of $40. *W*'s amount realized is the $50 value of *H*'s interest in asset *Y* received in exchange for her interest in *X*. The adjusted basis of property given by *W* is one-half of the community's basis in asset *X*, $10. As with *H*, *W*'s gain is not recognized. *Carrieres*, 64 T.C. at 965.

The terms "realized" and "recognized" are used in their technical sense. Gain or loss is realized when there has been a taxable event such as a sale or exchange of property. Realized gain or loss is generally required to be recognized, thereby having an impact on the computation of taxable income. I.R.C. § 1001(c) (1976). A number of provisions in the Code call for nonrecognition of realized gain. *See, e.g.*, *id.* §§ 351 (West 1978 & Supp. 1983), 1031 (1976), 1034 (1976 & Supp. V 1981).

interest in the community property as a whole,[200] the commentators suggest that the division is simply a partition of the property rather than an exchange.[201] Labelling the property division as a partition, however, does not change the fact that each party releases an interest in co-owned property in exchange for undivided ownership of the whole of one-half. Each spouse exchanges an interest in assets transferred to the other for that other spouse's interest in retained property. Realized gain or loss is the same however the transaction is analyzed. In an asset by asset exchange the amount realized may be computed by looking to the sum of one-half the fair market value of each asset retained by the spouse. When the transaction is viewed as an exchange of one-half of the whole for the whole of one-half, the amount realized is the same figure. The value of the whole, and the value of the one-half of the whole retained by a spouse, will be the sum of the values of the individual assets making up the aggregate. In the context of a marital property settlement, therefore, the aggregate-entity distinction has no economic or practical impact, and should not suffice to create an exchange in the one case but not in the other.[202]

Whether or not one accepts the description of a community property division as an exchange, commentators generally agree that allowing the division without recognition of gain is sound policy.[203] An equal division does not involve a substantial change in the parties' economic position. Neither party has more than he or she possessed before the division and may well have less. There is no change in economic wealth presenting an appropriate occasion for taxation.

More importantly, no conversion of community assets into another form of investment takes place. Each party retains a continuing investment in the community property, except that a one-half interest in the whole, or in

200. *See supra* note 102.

201. Glickfield, Rabow & Schwartz, *supra* note 71, at 322-23; Schwartz, *Divorce and Taxes: New Aspects of the* Davis *Denouement*, 15 U.C.L.A. L. REV. 176, 195-96 (1967); Note, *supra* note 68, at 483-85.

202. The entity approach to the disposition of assets has been rejected in other contexts. For example on the sale of a going business the tax consequences are determined using an asset-by-asset analysis of the transaction. State law does not recognize the sole proprietorship as a separate legal entity. Williams v. McGowan, 152 F.2d 570, 572 (2d Cir. 1945). The asset-by-asset approach must also be utilized when transferring a going business to a controlled corporation in exchange for stock in an I.R.C. § 351 (West 1978 & Supp. 1983) transaction, Rev. Rul. 68-55, 1968-1 C.B. 140; B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 3-23 to -24 (3d ed. 1971); or in a like-kind exchange under I.R.C. § 1031 (1976) where more than one asset is transferred, Treas. Reg. § 1.1031(d)-1(e). Contrast this asset-by-asset approach with the entity theory utilized in the sale of an incorporated business. Since a corporation is recognized as an entity separate from its owners, the sale of the entity is treated as the sale of the whole, the entity itself. By specific statute the sale of a partnership interest is also treated as a sale of an interest in the entity, but because of differing conceptual views of the status of a partnership as an aggregate or entity, the matter must be resolved by statute. *See* I.R.C. § 741 (1976). The partnership, however, is also treated as an aggregate with respect to certain assets. *Id.* § 751 (West 1982 & Supp. 1983). The marital community is not an entity separate from the marital partners who own the assets. To recognize it as such for tax purposes would contradict accepted principles applicable to dispositions of mixed groups of assets.

203. *See, e.g.*, Glickfield, Rabow & Schwartz, *supra* note 71, at 339-40; Schwartz, *supra* note 201, at 186-87.

each of the individual assets, has been exchanged for a separate full ownership interest in the retained one-half. As in the case of a like-kind exchange[204] or the tax free transfer of property to a controlled corporation,[205] the spouse's economic position remains tied to the property. In this regard, it is also important to recognize that, as in other nonrecognition transactions, an in-kind division of community property does not convert community assets into cash or other liquid property that may be used to pay tax.[206]

Finally, the revenue loss incurred by the Treasury due to the nonrecognition rule in community property divisions would not be great.[207] With appropriate basis rules, the taxation of appreciated property occurs at final disposition. The Code already adopts this philosophy in a number of areas and its application to marital property divisions is no less appropriate. These justifications for nonrecognition on equal division of community property apply with equal force to the division of marital property in a common law jurisdiction. They are sufficiently strong in both cases to justify passage of a statutory nonrecognition rule of uniform application.

C. Bargain and Sale Cases: Conversion into Cash or Property Other than Community Assets

The identification of an exchange in a division of jointly owned marital property may be insignificant where the policy decision not to tax has been made. Where cash, a note, or the separate property of one of the spouses is involved in the transaction, however, the authorities have uniformly relied on the exchange nature of the transaction to justify taxation.[208] Recogni-

204. I.R.C. § 1031(a) (1976) provides that "[n]o gain or loss shall be recognized if property held for productive use in trade or business or for investment . . . is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment."

205. *Id.* § 351(a) (Supp. V 1981) provides that "[n]o gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control . . . of the corporation."

206. Note, however, that in statutory nonrecognition transactions the conversion of property into cash, the receipt of boot, requires recognition of gain, at least to the extent of boot received. *Id.* §§ 351(b) (1976), 356(a) (West 1976 & Supp. 1983), 1031(b) (1976). The principal justification for nonrecognition is the taxpayer's continuing relationship with the investment. *See* B. BITTKER & J. EUSTICE, *supra* note 202, at 3-4 (§ 351); FEDERAL INCOME TAXATION, *supra* note 69, at 870 (§ 1031). To the extent that this relationship is terminated with the receipt of cash or other boot not provided for in the nonrecognition provision, the continuing relationship with the investment ceases, and gain is recognized to the extent of boot. A similar relationship exists with respect to a division of marital property on divorce. Each spouse maintains a continuing interest in marital property that justifies the judge-made nonrecognition rule applied to divisions of community property.

207. The staff of the Joint Committee on Taxation estimated that a nonrecognition rule treating property transfers incident to divorce as gifts with carryover basis would reduce revenues by less than $5 million annually. STAFF OF JOINT COMM. ON TAXATION, 98TH CONG., 1ST SES., DESCRIPTION OF H.R. 3475, TAX LAW SIMPLIFICATION AND IMPROVEMENT ACT OF 1983, at 10 (Comm. Print 1983).

208. Siewert v. Commissioner, 72 T.C. 326, 332 (1979); Carrieres v. Commissioner, 64 T.C. 959, 967-68 (1975), *acq.* 1976-2 C.B. 1, *aff'd per curiam*, 552 F.2d 1350 (9th Cir. 1977); Conner v. Commissioner, 34 T.C.M. (CCH) 1043 (1975); May v. Commissioner, 33 T.C.M.

tion of gain or loss may be appropriate where cash or a note is involved, but recognition where separate property is exchanged in-kind for joint property is questionable.

1. Exchange for Cash

A cash transaction such as that in *Rouse v. Commissioner*[209] is referred to as a "bargain and sale" in contrast to a "partition" of community property, and is fully taxable. One party is said to dispose of an interest in community property in exchange for consideration.[210] The existence of such consideration supposedly negates the idea that the division is a partition of assets.[211] The cash transaction differs significantly from an in-kind exchange, even where the cash is itself community property, since the spouse receiving cash for an interest in community property is converting an interest in property into cash. Unlike an in-kind exchange of property interests where gain or loss may be recognized on the future termination of a continuing interest in property, the receipt of cash completes the investment.[212] The termination of an investment in the property marks the point at which gain should be recognized.

Only one reported decision has addressed the receipt of community cash in exchange for a spouse's interest in other community property. In *Davenport v. Commissioner*[213] the wife received $502,900 of community cash plus certain property interests for the purpose of equalizing a division of Texas community property. The Commissioner argued that the property division was a taxable bargain and sale, citing *Rouse*.[214] The Tax Court disagreed and distinguished the transaction from *Rouse* on the grounds that both community and separate property were involved in *Rouse* whereas only community property was transferred in *Davenport*.[215] Contrary to the result in *Davenport*, however, recognition of gain may be appropriate where a spouse receives more than her share of community cash. Mrs. Davenport received a disproportionate share of community cash to equalize her husband's retention of other community assets and thereby con-

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(CCH) 256 (1974); Edwards v. Commissioner, 22 T.C. 65, 68-69 (1954); Brown v. Commissioner, 12 T.C.M. (CCH) 948 (1953); Rouse v. Commissioner, 6 T.C. 908, 914 (1946), *aff'd*, 159 F.2d 706 (5th Cir. 1947); *But see* Walz v. Commissioner, 32 B.T.A. 718, 719-20 (1935).

209. 6 T.C. 908 (1946), *aff'd*, 159 F.2d 706 (5th Cir. 1947).

210. Edwards v. Commissioner, 22 T.C. 65, 70 (1954); *Rouse*, 6 T.C. at 913.

211. Even an equal in-kind division of community property, however, is an exchange in which consideration is present. *See supra* notes 187-203 and accompanying text.

212. Property received in a nonrecognition transaction will obtain a basis either from property given up in the exchange or the carryover basis of the transferor. In either case gain or loss on ultimate disposition of the property will be measured by the difference between this basis, plus or minus adjustments to basis, and the amount realized. Unlike other property, cash does not fluctuate in value. Thus the basis of cash received in a nonrecognition transaction is always equivalent to its face value. On conversion of property into money the appreciation or depreciation of the property will never be recognized for tax purposes unless tax is imposed or some other provision is made to account for the basis inherent in the money.

213. 12 T.C.M. (CCH) 856 (1953) (appeal dismissed on stipulation).

214. 6 T.C. at 914.

215. 12 T.C.M. (CCH) at 858.

verted her interest in community assets into cash. Any appreciation in the property so exchanged was realized by her at the time of the exchange and her gain or loss was marked to the extent that property was converted into cash. Nonetheless, the Tax Court determined that the transfer of community cash was nontaxable.[216] One should note that the spouse receiving cash cannot claim that taxation is an undue burden since cash is available to pay the tax. Further, under current basis rules the spouse receiving cash obtains a step-up in basis without recognizing any gain.[217]

The receipt of cash in a marital property division is analogous to the receipt of cash in a statutory nonrecognition exchange. In most such transactions gain is recognized to the extent that cash is extracted from the continuing investment.[218] Applying this principle to the division of marital property results in the recognition of gain to a spouse receiving more than his or her share of the community cash. To the extent cash is received for an interest in community assets, the spouse's investment in those assets terminates since a disposition of property for cash occurs. The retention of a spouse's one-half share of community cash would not result in recognition, however. This cash, the spouse's retained one-half interest, is not received in exchange for a release of other assets.

An alternative proposal would treat the division of marital property as the dissolution of a partnership.[219] Cash received by a partner on liquidation of a partnership interest is treated as a partnership distribution under section 731.[220] The partner recognizes no gain unless cash received exceeds the partner's basis in his partnership interest. Where the partnership is completely liquidated, the partner's basis in other distributed assets is reduced by the cash received.[221] The partner is allowed to defer gain realized on the partnership liquidation until disposition of the in-kind assets. In a marital property settlement this approach requires recognition of gain only to the extent that a spouse receives cash in excess of the spouse's basis in retained community property. The basis of retained property would be reduced by the cash received in excess of the recipient's share of community cash. This approach requires complete recognition of gain in the

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216. *Id.*

217. Hjorth, *supra* note 180, at 242.

218. I.R.C. § 1031(b) (1976), for example, provides:

> If an exchange would be within the provisions of subsection (a) . . . if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

219. Hjorth, *supra* note 180, at 264-66.

220. I.R.C. § 731 (1976).

221. *Id.* § 731(a)(1) provides in the case of a distribution to a partner that "gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution . . . ." In addition, "[t]he basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest shall be an amount equal to the adjusted basis of such partner's interest in the partnership reduced by any money distributed in the same transaction." *Id.* § 732(b).

Rouse type of transaction where only cash is received. Where a spouse receives property in addition to cash, recognition would be deferred until disposition of the property. The partnership approach deprives the Treasury of tax on gain where a party has cashed out of an investment. As to separating individuals, however, it has the advantage of avoiding an additional financial burden at a difficult time.

To compare these possibilities, assume that a couple's assets consist of a house with a fair market value of $50,000 and a basis of $20,000, and cash of $50,000. The wife receives the house and the husband takes the cash in an equal division of community property. The husband has exchanged his one-half interest in the house for the wife's interest in $25,000 of cash. The husband's basis in his one-half interest in the house is $10,000, so he realizes a gain of $15,000. There is little reason to allow nonrecognition in this transaction even though the transaction is arguably a partition of the jointly held marital property. Although the husband is in the same economic position in terms of overall net worth before and after the division, he has converted his interest in the house into cash. In addition, the husband no longer possesses an asset that will allow the Treasury to recoup tax on a later disposition. As cash must be deemed to have a basis equal to its face value, disposition of the cash will not occasion recognition of gain or loss. If the husband escapes tax on this transaction he effectively obtains a tax-free step-up in basis,[222] thereby permanently escaping taxation.[223] If gain is recognized by the husband on this transaction, he can pay the tax without the added burden of converting additional assets into cash to meet his tax liability.

If the husband's gain is not recognized, the Treasury will recoup tax on the appreciation when the house is sold by the wife. Under current basis rules, the wife takes the house with the community's basis of $10,000.[224] Thus, the wife will realize the full amount of appreciation on disposition of the property. An unfair imposition of tax on the wife results because the husband is the one who converted an interest in property into cash with its attendant step-up in basis.

To examine the partnership approach assume the presence of an additional $60,000 of stock with a $50,000 basis to the marital community. Assume that the stock is divided equally between husband and wife so that the husband receives $50,000 of cash and one-half of the stock, and the wife receives the house and one-half of the stock. Again the husband has exchanged his one-half interest in the house for $25,000 cash. The reasons for recognizing gain considered in the first example still apply. The husband has converted his investment in the house into cash. The cash is

222. Hjorth, *supra* note 180, at 242.

223. The same tax result is obtained in this hypothetical whether gain is recognized under Professor Hjorth's partnership approach or under a rule requiring recognition of gain to the extent of cash. As described in the text, the difference occurs only when both cash and other property is received.

224. Harrah v. Commissioner, 70 T.C. 735, 748 (1978); Oliver v. Commissioner, 8 T.C.M. (CCH) 403, 430 (1949).

available to pay the husband's tax liability.[225] The partnership approach, however, defers recognition of this gain. Under the partnership approach the husband is allowed to extract cash in exchange for his interest in community property to the extent of his basis in community assets. The husband's share of the community basis in the house is $10,000 and in the stock is $25,000. The $25,000 cash received for his interest in the house does not exceed this combined basis, so the husband recognizes no gain. Recognition by the husband is deferred until disposition of his stock for $30,000. The receipt of cash reduces the husband's basis in the stock to $10,000.[226] On disposition of the stock the husband recognizes $20,000 of gain consisting of the $15,000 of deferred gain on the conversion of his interest in the house into cash, plus $5,000 of gain on his one-half interest in the stock. Although this deferral is technically achievable, there is little reason to allow the husband to avoid recognition of gain on the conversion of his interest in the house into cash simply because he receives an additional asset.

2. *Exchange for a Note*

A similar recognition issue exists with respect to the receipt of a note in exchange for an interest in community property. The exchange of property for a note is not significantly different from the exchange for cash. The principal distinction is that the note represents a right to future cash payments. The recipient of the note is again converting property into cash, only in this case the cash will be paid in the future. The courts have added an additional distinction that causes recognition in the exchange of a note for community property where the current receipt of cash may not. The courts have concluded that a note represents a promise payable out of the separate property of the obligor, specifically the obligor's post-divorce earnings, which are not community property.[227] The courts have thus identified a consideration in the form of separate property to support recognition of gain. Comparing this treatment with an equal division of community property where one spouse currently receives a disproportionate share of community cash in exchange for an interest in other community assets reveals a flaw in the present recognition scheme. The recipient of community cash may not be required to recognize gain,[228] even though

225. Note also that in a state such as California where only immediate tax consequences are taken into account, see *In re* Marriage of Fonstein, 17 Cal. 3d 738, 749-50, 552 P.2d 1169, 1176, 131 Cal. Rptr. 873, 880 (1976), the tax consequences of the property division may be accounted for in the property settlement.

226. Under Professor Hjorth's partnership approach the husband's basis in the marital community would be one-half of the total basis in community property, $10,000 for the house, $25,000 for the stock, and $25,000 for the cash, a total of $60,000. Hjorth, *supra* note 180, at 266-67. On the property division $50,000 of this basis is allocated to cash. This leaves only $10,000 of basis for allocation to the stock. The analogous partnership provision is I.R.C. § 732(b) (1976).

227. May v. Commissioner, 33 T.C.M. (CCH) 256, 258 (1974); Edwards v. Commissioner, 22 T.C. 65, 69 (1954); Brown v. Commissioner, 12 T.C.M. (CCH) 948, 952 (1953).

228. Davenport v. Commissioner, 12 T.C.M. (CCH) 856, 858 (1953) (appeal dismissed on stipulation).

that person can pay the tax due to the presence of the cash. The recipient of a promise to pay cash in the future is subject to immediate recognition of gain. The practical result is that parties with access to liquid cash may escape tax liability while those who must generate cash from future earnings are subject to tax.

Recognized gain on an exchange of community property for a note can be deferred under the installment sale rules of section 453,[229] which defer recognition until receipt of the cash payment. Here the distinction between separate and community property becomes paramount. The current receipt of cash in exchange for community property may not be taxable if the exchange is treated as a partition of community assets.[230] The receipt of cash at some point in the future requires recognition of gain on receipt of the cash because the authorities find an exchange, not from the conversion of property into cash, but from the fact that the cash represents the separate property of the payor. Whether the cash comes from the separate or community property of the payor, and whether it is received contemporaneously with the property settlement or at a later date pursuant to a note, the recipient of cash has converted an interest in property into cash. The conversion to cash justifies recognition of gain on the marital property division.

Recognition of gain on receipt of cash in exchange for an interest in marital property also eliminates the impact that the time of borrowing may have on the transaction. Some commentators have suggested that the adverse tax consequences of an equalizing note can be avoided with a pre-divorce borrowing from a third party lender.[231] Under state law both the debt and the proceeds of the borrowing belong to the community.[232] Thus a subsequent division allocating the loan proceeds to one party while the note is paid by the other is arguably tax free. In *Siewert v. Commissioner*[233] the Tax Court held, however, that since a pre-divorce borrowing to equalize a Texas community property division would be satisfied with the separate property of the husband, the transaction was a taxable sale.[234] Allowing this transaction to result in a tax treatment different from that applied to the transfer of an equalizing note to a spouse would elevate form over substance. More importantly, the fact remains that the party receiving the loan proceeds is converting an interest in property into cash. The conversion of property into either present or future cash remains the

229. I.R.C. § 453 (Supp. V 1981).

230. Davenport v. Commissioner, 12 T.C.M. (CCH) 856, 858 (1953) (appeal dismissed on stipulation).

231. Biblin, *Divorce, Taxes and Community Property: Some Current Cases, Problems and Concerns*, 30 S. CAL. TAX INST. 571, 580-82 (1978); Bost & Kimball, *Divorces in Community Property States: Selected Tax Problems*, 37 INST. ON FED. TAX'N § 35.02[5], at 35-18 (1979).

232. ARIZ. REV. STAT. ANN. § 25-215 (1976); CAL. CIV. CODE § 5116 (West 1983); IDAHO CODE § 32-906 (Supp. 1983); LA. CIV. CODE ANN. arts. 2359-2362 (Supp. 1983); NEV. REV. STAT. § 123.050 (1981); N.M. STAT. ANN. § 40-3-9 (1983); TEX. FAM. CODE ANN. § 5.62 (Vernon 1975); WASH. REV. CODE ANN. § 26.16.200 (Supp. 1983-1984).

233. 72 T.C. 326 (1976).

234. *Id.* at 335.

appropriate event for recognition of gain since, in either event, the recipient has terminated his or her investment in property.

Finally, the treatment of cash suggested here is consistent with the approach adopted by Congress for alimony payments since sections 71 and 215 also place the tax burden on the person receiving cash or other economic benefit.[235] Requiring recognition of gain on the receipt of cash in excess of a spouse's share of community cash simply places the burden of taxation on the party converting property into cash, that is, the person who realizes the economic value of appreciation to the date of conversion. The existing scheme causes an exactly opposite impact by placing the tax burden of appreciation on the person parting with cash in exchange for a spouse's interest in retained property. Requiring recognition of gain by the spouse cashing out an interest in marital property appropriately shifts the tax burden of the conversion of property to cash to the recipient of the cash.

Based on the foregoing, the author recommends that equal division of property on divorce, whether in a community property or common law jurisdiction, be treated as a statutory nonrecognition transaction. No gain or loss should be recognized where a spouse receives an interest in property, or is released from a marital obligation, in exchange for property transferred to a former spouse on divorce. The only exception is the recognition of gain by a spouse to the extent of cash or notes received in exchange for an interest in marital property.

D. Taxable Unequal Divisions of Jointly Owned Property

In between the bargain and sale cases, which require complete recognition of gain or loss, and the nontaxable equal division of jointly owned marital property, lies the analytically more difficult transaction involving an unequal division of community assets with an equalization provision. Difficulties arise where a major portion of the marital estate consists of a single asset or an indivisible collection of assets such as a going business. In such a case the spouse retaining the major asset must compensate the other with a transfer of separate property. The result is a taxable unequal division of jointly owned property. The equalization payment may include an in-kind transfer of separately owned assets, cash, or a promise to pay cash in the future. The courts have analyzed transactions with equalization payments by finding a taxable exchange of separate for community property, rather than a partition of assets.[236]

Although the authorities have uniformly adopted the rule that a completely equal division of jointly owned property on divorce is not taxable, both the Tax Court and the Internal Revenue Service have expressed a de

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235. *See supra* notes 15-16 and accompanying text.

236. *See* Carson v. Commissioner, 37 T.C.M. (CCH) 818 (1978); Carrieres v. Commissioner, 64 T.C. 959, 965 (1975), *acq.* 1976-2 C.B. 1, *aff'd per curiam*, 552 F.2d 1350 (9th Cir. 1977). No distinctions have been drawn between different forms of consideration.

minimis rule that allows a small deviation from equality.[237] As a practical matter this poses little difficulty since the imprecise science of appraisal leaves ample room to effect a mutually agreeable yet nominally equal property division.[238] Not surprisingly, most negotiation begins with the allocation of specific assets upon which a valuation is placed after division so as to give the appearance of an equal division.

The Tax Court addressed the problem of a truly unequal property division in *Carrieres v. Commissioner*.[239] In a California divorce the husband retained all of the stock of a family business. The stock represented more than one-half of the value of the entire community property. In order to equalize the property division the divorce court ordered the husband to give his wife a note in addition to the other community assets retained by her. After the divorce, and in settlement of a subsequent dispute, the husband settled the note with cash obtained partly from a borrowing from the corporation, partly from his one-half of the community cash on hand at the time of divorce, and partly from separate property cash. The Commissioner asserted that the wife was required to recognize gain on the sale of her interest in the stock of the family corporation. The wife claimed that the transaction was a tax-free partition of community property.

As described above, the Tax Court in *Carrieres* recognized the exchange nature of marital property divisions.[240] The court categorized taxable exchanges into two groups, an unequal division where one spouse receives more than one-half of the value of community assets, and an equal division where one spouse gives his note or separate property for substantially all of the other spouse's interest in community property.[241] The *Carrieres* property division fit into the latter category. The court held, however, that the use of separate property to acquire a part of the community assets

237. In Carson v. Commissioner, 37 T.C.M. (CCH) 818 (1978), the Tax Court said that a division of 46.2% of community assets to one party and 53.8% to the other was not sufficiently disproportionate as to allow the husband to recognize a loss on the exchange. *Id.* at 821; *see* Davidson v. Commissioner, 43 T.C.M. (CCH) 854 (1982) (appeal pending). The Service opined in Rev. Rul. 76-83, 1976-1 C.B. 213, that an equalizing note in the amount of $258 in a division of $300,000 of community property "is not of sufficient magnitude to prevent the division from being approximately equal." Further, the Tax Court in Conner v. Commissioner, 34 T.C.M. (CCH) 1043 (1975), stated that "[a] slight inequity in the division does not mandate a characterization of the transaction as a sale. Thus, a good faith attempt to divide the property with each spouse receiving property approximately equal in total value will be [a] nontaxable division despite the slight difference in value." *Id.* at 1045. The permissible degree of inequality is an open question.

238. Bost & Kimball, *supra* note 231, § 35.02[2], at 35-7.

239. 64 T.C. 959 (1975), *acq.* 1976-2 C.B. 1, *aff'd per curiam*, 552 F.2d 1350 (9th Cir. 1977).

240. *See supra* text accompanying notes 195-96.

241. 64 T.C. at 964. The cases generally cited for the proposition that an unequal division is a taxable exchange, including those cited in *Carrieres*, should be recognized as involving an exchange of community assets for cash or a note, the transformation of an interest in property into either present or future money. Long v. Commissioner, 173 F.2d 471 (5th Cir. 1949), *cert. denied*, 338 U.S. 818 (1949), differs only slightly in that the husband was required to make a current purchase of an annuity policy for the wife's interest in community assets. No cases have been found that require recognition in a purely unequal division of community property not involving cash or a note. *See* Hjorth, *supra* note 180, at 233 n.9.

should not preclude application of the nonrecognition principle to community property retained by a spouse. "Otherwise there would be introduced a 'cliff effect' under which the use of even $1 of separate property to remedy a disparity in the division of community property would render entirely inapplicable the protection of the nonstatutory nonrecognition principle . . . ."[242] The court concluded that its judge-made nonrecognition principle applies to the extent that an exchange of interests in community property takes place, but that gain will be recognized to the extent that a spouse exchanges his interest in community property for the separate property of the other spouse.[243] Thus, the wife's receipt of a note or other separate property for a portion of her community property required the recognition of gain.

Identifying the portion of a spouse's community property exchanged for the separate property of the other, and thereby computing the recognized gain, is the most difficult part of the *Carrieres* opinion. The court's approach is best analyzed by studying the specific facts of the case. The net value of community assets was approximately $388,200.[244] The husband, George, received community cash of $15,200, a one-half interest in a parcel of community real estate, and the stock of the family business valued at $241,000. The wife, Jean, received a one-half interest in the real estate, community cash of $15,200, other community assets with a net value of $61,700, and George's note for $89,600 payable over a period of twelve years.[245] Before the divorce court entered final judgment, George agreed to pay the note in a lump sum. He obtained cash by borrowing $65,000 from the family corporation, using $13,100 of the community cash received in the initial settlement, and contributing $11,500 of cash from his separate property. The property division following the settlement is summarized in Table I.

TABLE I

GEORGE		JEAN	
Real property	$ 27,500	Real property	$ 27,500
Stock	241,000	Community assets	61,700
Cash	2,000	Community cash	28,300
Less cash paid	(76,500)	Cash from husband	76,500
TOTAL	$194,000	TOTAL	$194,000

The Tax Court concluded that Jean received the $13,100 of community cash from George as part of the tax-free division of community property.[246] The remaining $76,500 of the cash came from George's separate

242. 64 T.C. at 965.
243. *Id.* at 965-66.
244. For convenience all figures are rounded to the nearest $100.
245. The figures given here are net of community liabilities. Mrs. Carrieres took two properties subject to encumbrances totalling approximately $9600.
246. *Id.* at 967. The court relied on the holding in Davenport v. Commissioner, 12

property[247] and was therefore received by Jean as consideration for her sale of community property. Jean's gain on this sale was recognized.

Recognition of gain on Jean's sale of community property for cash required an allocation of the cash sales price to particular assets. The allocation was necessary to identify the property given up in the exchange, ascertain its basis, and compute gain.[248] The court began its inquiry by looking to the intent of the parties. This investigation revealed that George's separate property was exchanged for the stock, the major community asset.[249] Thus Jean's gain was computed using her basis in the stock. She received $120,500 of assets for her one-half interest in the stock. $76,500 of this amount came from George's separate property and was subject to tax, while $44,000 of the proceeds represented a nontaxable exchange. The court thus concluded that Jean recognized $76,500/$120,500, approximately 63.5%, of her realized gain on the stock sale.[250]

The Service acquiesced in *Carrieres*, but in the result only.[251] Prior to *Carrieres* the Service had indicated, albeit in a different situation, that it preferred an alternate approach to the allocation problem. In Revenue Ruling 74-347 the Service ruled on the tax consequences of an unequal division of jointly owned property where no separate property was given to equalize the disparity.[252] The assets of husband and wife totalled $110,000. $70,000 of that property was jointly held. The remaining $40,000 was the separate property of the husband. The divorce decree awarded the wife jointly owned property with a net fair market value of $55,000. The remaining $15,000 of joint property was awarded to the husband along with his $40,000 separate property. In table form, the division looked like this:

T.C.M. (CCH) 856 (1953). *See supra* notes 213-17 and accompanying text (nontaxability of receipt of excess share of community cash).

247. 64 T.C. at 967. Jean argued that the proceeds of George's borrowing from the corporation were community property and thus received by her as part of the tax-free property division. The court's response stated only that "[t]he loan was made from a corporation all of the stock of which was set aside to George as his separate property. In no manner, technical or nontechnical, could the proceeds of the loan George took from Sono-Ceil Company be considered other than his separate property." *Id.*

248. The court recognized the difficulty with this allocation by asking, "[w]here a spouse conveys his interest in both high-basis and low-basis community assets to his spouse for a consideration including both separate and community assets, should he be deemed to have 'sold' the low-basis community assets and 'divided' the high-basis community assets, or vice versa?" *Id.* at 966.

249. *Id.* Commentators were quick to recognize the flexibility provided by the court's allocation. *See, e.g.*, Bost & Kimball, *supra* note 231, § 35.02[4], at 35-17; Hjorth, *supra* note 176, at 247-48. Any person aware of the result would allocate separate assets to an exchange of high-basis community property. Except in a case involving a single major asset such as *Carrieres*, the allocation process is relatively free from restraint. The court in *Carrieres* did not deal with the case where the intent of the parties is not easily ascertained.

250. 64 T.C. at 967-68.

251. 1976-2 C.B. 1.

252. Rev. Rul. 74-347, 1974-2 C.B. 26.

TABLE II

HUSBAND		WIFE	
Joint property	$ 15,000	Joint property	$ 55,000
Separate property	40,000		
TOTAL	$ 55,000	TOTAL	$ 55,000

The Service opined that insofar as a division of jointly owned property occurred, the transaction was tax free, but this result applied only to $35,000 of the property received by the wife, representing her one-half share of the jointly held property. The remaining $20,000 of jointly owned property received by the wife was said to have been received for her release of marital rights.[253] Thus the husband realized the fair market value of a release of his wife's marital rights in exchange for $20,000 of joint property. The Service ruled that this was a taxable exchange under *United States v. Davis*.[254] The value of the release realized by the husband was equivalent to the value of the property given in exchange, the $20,000 excess of joint property retained by the wife.

Unlike the court's quest in *Carrieres* for the identity of the specific asset exchanged in the recognition transaction, the Service determined the basis of property given up by the husband in Revenue Ruling 74-347 as a proportion of the husband's total basis in the joint property.[255] The Service concluded that since $20,000 of the $55,000 of joint property retained by the wife was received in exchange for her release of marital rights, $20,000/$55,000 of the total basis of the property retained by the wife was the basis of property given up by the husband. The Service used this basis to compute the husband's recognized gain.[256]

Identifying recognized gain as a proportionate part of the gain realized

253. 1974-2 C.B. at 27.

254. 370 U.S. 65 (1962).

255. 1974-2 C.B. at 27; *see* Conner v. Commissioner, 34 T.C.M. (CCH) 1043, 1046 (1975).

256. Although gain was determined by looking at the assets in the aggregate, the ruling looked to individual assets to determine the adjusted basis of property given up by the husband. The adjusted basis of all jointly held property received by the wife was $29,200. $4000 of this basis was attributable to household furniture with a fair market value of only $2000. Because no loss can be recognized on the sale of such a personal item, see I.R.C. §§ 165 (West 1978 & Supp. 1983), 262 (1976), the ruling provided that the basis of the furniture in excess of fair market value could not be used in computing the husband's gain on the transfer. The basis of property retained by the wife was thereby reduced to $27,500. The husband's basis in property given up was computed as ($27,500) ($20,000/$55,000) = $10,000. The husband's realized and recognized gain was $10,000, ($20,000 - $10,000).

Professor Hjorth criticized the ruling for using an aggregate approach for determining gain while using an asset-by-asset approach for determining basis. Hjorth, *supra* note 180, at 254. The gain derived from the formula in the ruling, however, is simply the algebraic sum of the gain realized on each asset. Whether gain is computed in the aggregate or on an asset-by-asset basis makes no difference to the result in this circumstance. This result is consistent with that obtained on the transfer of an aggregate of assets to a controlled corporation in exchange for stock where gain is recognized because of the presence of boot. I.R.C. § 351(b) (1976). The single figure for gain realized is the sum of the gain on each individual on each asset produces a more realistic result than the *Carrieres* court's focus on a single asset. This approach recognizes that each asset given up by a spouse is exchanged for a proportionate part of each asset received. The approach is also less complex because it eliminates the need to identify a specific asset as the subject of the recognition portion of the exchange.[257] The holding in Revenue Ruling 74-347,[258] however, produces the inequity generated by the Supreme Court's opinion in *United States v. Davis*.[259] The husband parts with a disproportionate share of jointly owned property, yet, despite this loss, he is also burdened with a tax on the transfer.

In the context of a community property state the ruling presents a second, less practical, but more analytical defect.[260] Where support is separately provided for, a wife in a community property state receiving more than one-half of the community assets cannot be said to give up marital rights in exchange for the property, since she has no additional rights to give.[261] If this is true, the Service's conclusion that the husband gives in excess of his one-half share of community property in exchange for a release of the wife's marital rights cannot be supported.[262]

A superior analysis of the unequal division follows from the recommendation that in-kind marital property divisions be treated like other statutory nonrecognition exchanges. Equal or not, each party to a marital property settlement can be said to receive the equivalent of the bundle of rights each possessed prior to divorce. There is no accession to economic wealth in this exchange and thus no event upon which a tax should be imposed. Furthermore, even if gain is technically realized, the gain has not been extracted from a continuing investment in property. Because ap-

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asset determined by comparing each asset's basis with its fair market value. *See* Rev. Rul. 68-55, 1968-1 C.B. 140; B. BITTKER & J. EUSTICE, *supra* note 202, at 3-24.

257. This conclusion can be demonstrated by applying the approach of Rev. Rul. 74-347, 1974-2 C.B. 26, to the facts of *Carrieres*. Jean received $117,500 of community property plus $76,500 of cash from George's separate property in exchange for her interest in the community property retained by George. Thus, $76,500/$194,000 or 39.4% of the property obtained by Jean was realized in a taxable sale. Her basis for the property given up would be 39.4% of the aggregate basis of the property retained by George. In effect Jean would be deemed to have transferred her interest in each community asset retained by George for both the separate property cash and George's interest in her retained community assets. Contrast this with the result reached in *Carrieres* where the court held that the cash received by Jean was received solely in exchange for her interest in the stock retained by George.

258. 1974-2 C.B. 26.

259. 370 U.S. 65 (1962).

260. Several community property states sanction an unequal division of community property in the discretion of the trial court unless the trial court makes such an arbitrarily disproportionate division as to be inequitable. *See supra* note 174.

261. Biblin, *supra* note 231, at 583-84. One could argue that the husband is giving up additional property for freedom or in purchase of an expedient settlement. If true, the husband is making a payment for status. Such status gain, at least to the wife, is not taxable under *Davis*, 370 U.S. at 73 n.7.

262. This argument might be taken a step further. If the wife has nothing to give up, the husband has realized nothing on the exchange of a disproportionate share of community property. The husband's amount realized for this property is zero, so there is a realized loss on the unequal division that could be recognized, but only if the exchange occurs after divorce. *See* I.R.C. § 267 (West 1978 & Supp. 1983).

preciation may always be taxed upon the ultimate disposition of the appreciated asset, nonrecognition is the most appropriate and equitable result for both parties. Thus the nonrecognition rule should be applied to any in-kind division of property incident to divorce or separation. Where a spouse terminates an interest in marital property in exchange for cash or a note, however, gain should be recognized to the extent of the cash or note.

E. Miscellaneous Problems

The nonrecognition model solves other problems encountered on division of community property in addition to the unequal division and cash transaction issues. These problems include release of indebtedness, assignment of income, and recognition of loss.

1. Release of Indebtedness

Where encumbered property or community debt is divided in a property settlement, most courts look to the net value of property retained by each spouse to determine whether a tax free equal division has occurred.[263] Recognize, however, that the community liability assumed by a spouse on divorce will be satisfied out of the separate property of the spouse. In this sense the transaction is similar to an equalizing note payable out of the obligor's separate property, or an immediate transfer of cash from the obligor's separate property.[264]

The role of liabilities in a marital property division can be analyzed with the principles applied in statutory nonrecognition transactions. The amount realized on the disposition of property includes the amount of any indebtedness assumed by the transferee or to which the transferred property is subject.[265] Thus the amount realized by a spouse transferring an interest in encumbered property or community debts includes the indebtedness assumed by the other spouse.[266] The assumption of a spouse's share of community debt may be viewed as the payment of cash that the recipient uses to satisfy the creditor.[267] If the receipt of cash in excess of a spouse's share of community cash results in the recognition of gain,[268] then the relief from indebtedness may also result in recognition of gain. Unlike

263. Davidson v. Commissioner, 43 T.C.M. (CCH) 854, 857 (1982) (appeal pending); Carson v. Commissioner, 37 T.C.M. (CCH) 818, 819 (1978); Carrieres v. Commissioner, 64 T.C. 959, 964-65 (1975), *acq*. 1976-2 C.B. 1, *aff'd per curiam*, 522 F.2d 1350 (9th Cir. 1977); Wren v. Commissioner, 24 T.C.M. (CCH) 290, 293 (1965).

264. As a practical matter, both an assumed community debt and an equalization note would be paid out of the spouse's post-divorce earnings, which are separate property. *See, e.g.*, Siewert v. Commissioner, 72 T.C. 326, 335 (1979).

265. Commissioner v. Tufts, 103 S. Ct. 1826, 1831, 75 L. Ed. 2d 863, 871 (1983); Crane v. Commissioner, 331 U.S. 1, 14 (1946).

266. For convenience the term "indebtedness" is used to include nonrecourse debt as well as personal liabilities. "Assumption" includes the receipt of property subject to a nonrecourse liability even though this usage is technically incorrect.

267. *See, e.g.*, United States v. Hendler, 303 U.S. 564, 566 (1938).

268. *See supra* notes 209-26 and accompanying text (recognition of gain to extent of excess community cash received).

the recipient of cash, however, the spouse relieved of an indebtedness does not obtain liquid assets with which to pay tax. This paramount policy consideration recommends application of a nonrecognition principle to indebtedness.

Again, reference to statutory nonrecognition rules provides guidance. In corporate organizations and reorganizations gain is not recognized on an assumption of liabilities unless the transaction is motivated by tax avoidance or the liabilities assumed exceed the transferor's basis in the transferred property.[269] Tax motivated divorce is probably not a problem for these purposes. It seems reasonable, however, to provide for recognition of gain where a spouse is relieved of liabilities in excess of the spouse's basis in community property transferred to the other spouse. Such a case would arise on divorce only where the separating couple has invested heavily in leveraged tax shelters in which depreciation and other artificial accounting losses have reduced basis below the indebtedness, or where the couple has undertaken extensive post-acquisition borrowings of cash in excess of their total basis in community assets.

Treating a release of community indebtedness as a cash payment primarily affects the basis of retained property. When incurred, debt either generates cash with a basis equal to face value[270] or creates basis in an asset acquired with a purchase money borrowing.[271] A spouse's release from an obligation to return that spouse's share of the borrowed capital must, therefore, result in an adjustment to basis.[272] Withdrawal of cash in the form of a release from an indebtedness can be viewed as a reduction of the spouse's cost or after-tax investment in retained property reflected in an adjustment to the basis of that property.[273]

Assumption of liability problems also arise where one spouse agrees to pay the tax liability of the other. The assumption of this obligation could produce taxable gain to the benefited spouse[274] or be treated as part of the amount realized by the benefited spouse on exchange of marital property.[275] Again the transaction is similar to a cash payment to the benefited spouse who uses the cash to pay taxes. But under the foregoing analysis

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269. I.R.C. § 357 (1976 & Supp. V 1981).

270. Such cash could be used to create basis when expended in acquisition of other assets.

271. Crane v. Commissioner, 331 U.S. 1, 13-14 (1946).

272. *See, e.g.*, I.R.C. §§ 358(d), 1031(d) (1976 & Supp. V 1981). For an in-depth discussion of basis considerations in the divorce setting, see *infra* notes 307-46 and accompanying text.

273. Under the cash analogy, release of the indebtedness is identical to the receipt of cash, which has a basis equal to face value. The basis allocated to cash must come from a reduction in the basis of other assets. In Carrieres v. Commissioner, 64 T.C. 959 (1975), *acq.* 1976-2 C.B. 1, *aff'd per curiam*, 552 F.2d 1350 (9th Cir. 1977), Jean took property subject to encumbrances. George was thereby relieved of his community share of this liability, increasing his amount realized. 64 T.C. at 961. Under the substituted basis approach described *infra* notes 315-18 and accompanying text, the husband's basis in the stock would be reduced by the amount of his share of the encumbrances.

274. Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929).

275. *See, e.g.*, Diedrich v. Commissioner, 457 U.S. 191 (1982); Johnson v. Commissioner, 495 F.2d 1079 (6th Cir. 1974).

recognition is inappropriate and would create hardship to a spouse potentially lacking liquid assets with which to pay the tax. Gain or loss can be deferred with an appropriate adjustment to the basis of property retained by the spouse.

2. Assignment of Income

In *Johnson v. Commissioner*[276] the Ninth Circuit Court of Appeals held that a wife was taxable on collection of accounts receivable by her ex-husband who had obtained the wife's interest in unrealized receivables in a community property division.[277] The court reasoned that under California community property law the wife possessed a one-half interest in the earned income represented by receivables from her husband's law practice.[278] Although California law allows one spouse to transfer income to the other, the assignment of income principles of *Helvering v. Horst*[279] precluded an assignment of the tax incidence of the income.[280]

The assignment of income doctrine is intended to avoid a transfer of income to another by the person earning it.[281] The fallacy of applying this doctrine to a marital property division is demonstrated by the facts of the *Johnson* case itself. As part of the property settlement the husband agreed to pay the wife's tax liability for the year in which the receivables were collected. The husband contended that the income was taxable to the wife. Although the Ninth Circuit's opinion is obscure on this point, it seems safe to assume that the wife was in the lower tax bracket so that taxing one-half of the receivables to her reduced the couple's combined tax liability. Thus the result of the Ninth Circuit's opinion in *Johnson* resulted in a shift of income from the higher bracket wage earner to his ex-spouse.

In different contexts the assignment of income doctrine is characterized as a flexible concept that may yield to congressionally stated nonrecognition policies in an appropriate case. For example, the transfer of receivables to a controlled corporation as part of the transfer of a going business will not invoke the assignment of income doctrine to require the transferor to recognize income on the receivables.[282] A similar conflict arises in a marital property division between the judicial doctrine that income is taxed to the person who earns it and the judicial nonrecognition rule for community property settlements. The result in *Johnson* serves neither.

One-half of the earnings of a spouse in a community property state be-

276. 135 F.2d 125 (9th Cir. 1943).
277. *Id.* at 130.
278. *Id.* at 129-30.
279. 311 U.S. 112 (1940).
280. 135 F.2d at 128. Otherwise, a man with a rich wife would be allowed to transfer his wife's share of earned and uncollected income to the community himself, thereby taking that amount out of the wife's higher tax bracket and vice versa. *Id.*
281. Commissioner v. Tower, 327 U.S. 280, 290-91 (1946); Burnett v. Leininger, 285 U.S. 136, 142 (1932); Lucas v. Earl, 281 U.S. 111, 114-15 (1930).
282. Hempt Bros. v. United States, 490 F.2d 1172, 1177-78 (3d Cir. 1974), *cert. denied*, 419 U.S. 826 (1974); Briggs v. Commissioner, 15 T.C.M. (CCH) 440, 451 (1956).

long to and are taxable to the nonearner spouse.[283] Taxing that income to the spouse who actually earns it, however, does not harm the basic principle of assignment of income, to wit, income is taxable to the person who earns it.[284] Assignment of income principles are not compromised where receivables are taxed either to the spouse who produces the income or to the nonearner spouse who may retain a one-half interest.

This analysis also applies to a division of future pension benefits. At least one commentator has suggested that assignment of income principles require recognition of ordinary income to the transferor of a community property interest in a vested pension, either at the time of divorce or at the time the pension is collected by the estranged spouse.[285] As a matter of simplicity and sound tax policy, it makes more sense to tax the spouse who retains these benefits at the time the pension is collected. Again, assignment of income principles are not compromised where the burden of taxation falls on the person whose earnings create the income and who receives the economic benefit.[286]

3. Recognition of Loss and the Related Issue of Section 1239

If, as recommended, gain is recognized in a marital property division to the extent of an exchange of property for cash, recognition of loss must also be considered. Under current law neither gain nor loss is recognized in an equal division of community property.[287] Recognized loss may be generated in a bargain and sale case, however, where community property is purchased from a spouse for cash or where a taxable unequal division of community property occurs.[288] Depending on timing, the loss may be subject to section 267, which disallows the deduction of loss on a sale of property to a spouse.[289]

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283. Poe v. Seaborn, 282 U.S. 101, 111-13 (1930); *see also* United States v. Mitchell, 403 U.S. 190, 194-97 (1971) (wife personally liable for federal income taxes on her one-half interest realized during marriage, notwithstanding subsequent renunciation under state law).

284. Indeed, Bost and Kimball point out that the *Johnson* result creates a hardship where the spouse transferring an interest in earned but uncollected income remains accountable for his or her own tax liability. The more income collected by the spouse retaining the receivables, the greater the tax liability of the other spouse. Bost & Kimball, *supra* note 231, § 35.02[6], at 35-21 to -22.

285. *See*, Halpert, *supra* note 20, at 34-73. For a discussion of the problems of dividing an interest in a qualified plan, see Haroutunian & Marks, *Designating Court Orders and Agreements for Dividing Marital Interests in Qualified Plans*, 58 J. TAX'N 322 (1983).

286. The same approach may be applied to royalties and other forms of earned but uncollected receipts divided on divorce. If these items are retained by the spouse who earned them, or by the spouse who retains the underlying property producing the royalty, there is no loss to the Treasury and no basis for asserting assignment of income principles. Indeed, higher revenue may result since the recipient spouse may be in a higher bracket as a result of the change in his or her filing status following divorce. In any event, this approach taxes the income at the level of the person who actually earned the income, the result sought to be achieved by forbidding anticipatory assignments of income.

287. Carrieres v. Commissioner, 64 T.C. 959, 964 (1975), *acq.* 1976-2 C.B. 1, *aff'd per curiam*, 552 F.2d 1350 (9th Cir. 1977); Walz v. Commissioner, 32 B.T.A. 718, 719 (1935).

288. Siewert v. Commissioner, 72 T.C. 326, 333 (1979); Rouse v. Commissioner, 6 T.C. 908, 914 (1946), *aff'd*, 159 F.2d 706 (5th Cir. 1947).

289. I.R.C. § 267 (West 1978 & Supp. 1983).

Application of section 267 depends upon marital status at the time of transfer. In *Deyoe v. Commissioner*[290] the Tax Court held, for purposes of section 1239, which also applies to a transaction between the taxpayer and his spouse,[291] that a divorcing couple remain husband and wife, and therefore related parties, until the decree of divorce becomes final.[292] Thus whether a taxable transfer of community property occurs between related parties in the divorce situation depends upon the date on which the sale occurs. This is a factual inquiry focusing on the date on which the parties intended to transfer the benefits and burdens of ownership.[293] The *Deyoe* court rejected the taxpayer's argument that section 1239 is not applicable to a sale between divorcing persons because they do not derive the benefit that section 1239 was designed to avoid, a step up in basis within a single economic community at capital gains rates.[294]

In *DuPont v. Commissioner*,[295] however, the taxpayers successfully avoided both sections 267 and 1239 by careful planning. The parties negotiated a property settlement agreement prior to entry of the decree of divorce, but the agreement was not effective under state law until approved by the divorce court. Neither the agreement nor a bill of sale for the transferred property were delivered until after the decree of divorce. The Tax Court observed that the parties did what they could to insure that the property settlement agreement was "made concurrent with the divorce rather than in consideration of it."[296]

In *Siewert v. Commissioner*[297] the taxpayer used section 267 to his advantage. Siewert transferred cash, a note, and some community assets to his wife in a Texas marital property settlement. The transfer, property settlement agreement, and decree of divorce were all effective on the same date. Rejecting Siewert's argument that the property settlement was a nontaxable division of community property with a carryover basis, the Tax Court held that the community property division was a taxable exchange and that the husband's basis in the assets equalled one-half of the community's basis plus his cost for the one-half purchased from his wife.[298] The resulting basis figure was lower than the community's basis in Siewert's retained assets. Siewert then asserted that the property exchange was subject to the nonrecognition rule of section 267. If the wife's realized loss was not allowed under section 267, Siewert could claim the relief provided by section 267(d), which allows the use of the transferor's higher basis for

290. 66 T.C. 904 (1976).
291. Section 267 bars recognition of loss on sales between related parties. Related parties are defined to include the taxpayer's family including the taxpayer's "spouse." I.R.C. § 267(c)(4) (1976). Section 1239 requires recognition of ordinary gain on sale of property that will be depreciable in the hands of a related purchaser. Related persons are defined to include "a husband and wife." *Id.* § 1239(b)(1) (West Supp. 1983).
292. 66 T.C. at 913-14.
293. *Id.* at 910.
294. *Id.* at 914-15.
295. 37 T.C.M. (CCH) 115 (1978).
296. *Id.* at 125.
297. 72 T.C. 326 (1979).
298. *Id.* at 337-38.

property acquired in a transaction to which section 267 applied and which is later sold at a gain.[299] The Tax Court, agreeing, held that the property settlement was an integral part of the divorce decree and took effect simultaneously with entry of the final divorce judgment.[300] The court rejected suggestions that section 267 is not applicable to sales transactions in connection with divorce, stating that section 267 contains an absolute prohibition against recognition.[301]

As asserted by the taxpayer in *DuPont* and the government in *Siewert*, section 267 is designed to disallow a deduction for losses incurred within a single economic unit.[302] This evil does not exist in the case of a divorcing couple since the economic unit is separated into distinct parts dealing at arm's length. Further, divorce is an action with significant consequences apart from taxation and is not likely to be motivated by tax avoidance. Sophisticated tax planning, an element not universally available, can make a large monetary difference in this area. For purposes of section 1239 the Treasury has promulgated a regulation providing that a husband and wife are not related parties when they are legally separated under interlocutory decree of divorce.[303] Consistency demands that this same rule apply to section 267.[304]

Regardless of section 267, an independent reason for disallowing recognition of loss on a marital property division of the kind found in *Siewert* is that statutory nonrecognition provisions expressly disallow recognition of loss in a transaction where boot is received, even though realized gain would be recognized should it occur.[305] Loss realized in a nonrecognition exchange is deferred in the basis of nonrecognition property until disposition of that property in a recognition transaction. In a marital property division the statutory nonrecognition model would bar recognition of loss until the loss is fixed by disposition of the retained community property. The current nonrecognition rule accomplishes this result, although current basis rules result in a shift of tax benefits between the spouses.

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299. I.R.C. § 267(d) (1976) provides that if

> (1) in the case of a sale or exchange of property to the taxpayer a loss sustained by the transferor is not allowable to the transferor as a deduction by reason of subsection (a)(1) . . . ; and
>
> (2) . . . the taxpayer sells or otherwise disposes of such property . . . at a gain, then such gain shall be recognized only to the extent that it exceeds so much of such loss as is properly allocable to the property sold or otherwise disposed of by the taxpayer.

300. 72 T.C. at 338-40.

301. *Id.* at 340. Quoting McWilliams v. Commissioner, 331 U.S. 694, 699 (1947), the court said, " '[The predecessor of sec. 267] states an absolute prohibition—not a presumption—against the allowance of losses on any sales between the members of certain designated groups.' " 72 T.C. at 340.

302. McWilliams v. Commissioner, 331 U.S. 694, 699-701 (1947); Hassen v. Commissioner, 599 F.2d 305, 309 (9th Cir. 1979); Merritt v. Commissioner, 400 F.2d 417, 419 (5th Cir. 1968); H.R. REP. No. 1546, 75th Cong., 1st Sess. 26 (1937), *reprinted in* 1939-1 C.B. (pt. 2) 704, 723.

303. Treas. Reg. § 1.1239-1(c)(1).

304. Bost & Kimball, *supra* note 231, § 35.02[8], at 35-25.

305. I.R.C. §§ 351(b)(2), 356(c), 1031(c) (1976).

Any nonrecognition rule for loss must provide an exception for the spouse who receives only money, since there are no assets into which a loss may be deferred. The partnership provisions of the Code contain a model for this transaction. Section 731(a)(2) provides that no loss shall be recognized on a distribution to a partner except distributions in complete liquidation of a partnership interest where no property other than money and unrealized receivables is received.[306] Loss is recognized to the extent of the excess of the partner's adjusted basis in the partnership interest over the sum of money plus the basis of unrealized receivables. A similar rule should be applied in the divorce context. No loss will be recognized except to a spouse who exchanges an interest in marital property for cash in an amount less than the spouse's basis in the marital property given up. This provision is clear and leaves little room for manipulation requiring sophisticated tax planning. Only the spouse who completely cashes out his or her investment in marital property for less than basis will be permitted to recognize a loss.

V. Basis in Tax-Free Divisions

A. *General Provisions*

Perhaps because the impact of basis determinations is not immediate, most authorities consider the role of basis in marital property divisions only as an afterthought. Only a few cases have considered the question of the basis of property after a marital settlement.[307] Under existing law, the marital community's basis in each asset carries over to the spouse who receives the property in a tax free division.[308] Thus the spouse who receives low basis property will be responsible for the tax on pre-divorce appreciation. Conversely, the spouse receiving high basis property is burdened with less future tax liability. Consequently, an equal division of marital property by value will subsequently result in disparate impact on the parties.

Rouse v. Commissioner[309] provides the initial framework for considering the basis of property in a nontaxable community property division. Mr. Rouse acquired his wife's interest in community property with a cash pay-

306. *Id.* § 731(a)(2) provides:

> [L]oss shall not be recognized to such partner, except that upon a distribution in liquidation of a partner's interest in a partnership where no property other than that described in subparagraph (A) or (B) is distributed to such partner, loss shall be recognized to the extent of the excess of the adjusted basis of such partner's interest in the partnership over the sum of—
> (A) any money distributed, and
> (B) the basis to the distributee, as determined under section 732 [the partnership's basis], of any unrealized receivables . . . and inventory . . . .

307. Long v. Commissioner, 173 F.2d 471, 474 (5th Cir. 1949); Siewert v. Commissioner, 72 T.C. 326 (1979); Harrah v. Commissioner, 70 T.C. 735, 748 (1978); Rouse v. Commissioner, 6 T.C. 908 (1946), *aff'd*, 159 F.2d 706 (5th Cir. 1947).

308. Harrah v. Commissioner, 70 T.C. 735, 748 (1978); Carrieres v. Commissioner, 64 T.C. 959, 964 (1975), *acq.* 1976-2 C.B. 1, *aff'd per curiam*, 552 F.2d 1350 (9th Cir. 1977).

309. 6 T.C. 908 (1946), *aff'd*, 159 F.2d 706 (5th Cir. 1947).

ment. The Tax Court and the Fifth Circuit Court of Appeals held that Rouse acquired his wife's interest in community property in a taxable bargain and sale so that his basis for the acquired interest was his cost, the amount paid to the wife for her interest.[310] The Tax Court added in dictum, however, that where each party exchanges a vested one-half interest in the whole of the community property for an undivided interest in the whole of one-half "there would be no resulting taxable gain, and no change in the basis of any of the property by reason of the settlement."[311] The recitation of this latter basis rule by the Tax Court without analysis is understandable since the question of basis in a nontaxable division was not before it. *Rouse*, however, has become the seminal authority on the issue, and succeeding opinions have adopted its basis rule without further exploration.[312]

The *Rouse* rule offers the advantage of simplicity. Each spouse receiving property in a nontaxable division of marital property need only know the adjusted basis of that asset to the community. There is no adjustment to basis and no allocation problem involved. The approach can produce substantial inequity, however. A property division that appears equal based on fair market values may be grossly disproportionate when the tax consequences of subsequent disposition are considered. The superficial simplicity of the carryover basis rule of *Rouse* is outweighed by the difficulty of negotiating an equitable division of several assets with different bases. The problem is particularly acute when a going business or the stock of a closely held corporation is involved. The refusal of some state courts to consider the future tax consequence of property division compounds the difficulty.[313] The party anticipating an award of low basis assets is forced to agree to an unequal division of community assets in order to avoid a court-imposed "equal" division with unfavorable tax consequences. This tactic is dangerous in itself since an unequal division of value to equalize future tax costs generates a risk that the transaction will fail to qualify for nonrecognition treatment. One attempt at avoiding the problem would recite in the settlement agreement that the division is approximately equal.[314] The tax system should not demand this sort of fudg-

310. 6 T.C. at 914; 159 F.2d at 707.

311. 6 T.C. at 914.

312. *See, e.g.*, Carrieres v. Commissioner, 64 T.C. 959, 964 (1975) (citing *Wren & Oliver*), *acq*. 1976-2 C.B. 1, *aff'd per curiam*, 552 F.2d 1350 (9th Cir. 1977); Wren v. Commissioner, 24 T.C.M. (CCH) 290, 294 (1965) (relying exclusively on *Rouse*); Oliver v. Commissioner, 8 T.C.M. (CCH) 403, 430 (1949) (relying exclusively on *Rouse*). The *Rouse* approach to basis follows from the analogy to a partition of jointly owned assets. When a partition of a single asset takes place each party owning one half of the asset receives one-half of its basis. If a community property division is not taxed because it represents merely a partition of jointly held assets, then it is arguably inconsistent to use a carryover basis. If each spouse owns one-half of the whole, then each spouse must also be entitled to one-half of the whole basis. The partition should, therefore, result in a partition of basis with each spouse receiving one-half.

313. *See, e.g.*, *In re* Marriage of Fonstein, 17 Cal. 3d 738, 552 P.2d 1169, 131 Cal. Rptr. 873 (1976); *see also* Biblin, *supra* note 231, at 585.

314. *See* Bost & Kimball, *supra* note 231, § 35.02[2], at 35-7. Fortunately the trend is

ing in the drafting of a property settlement as the only route to an equitable solution. Equity in taxation of marital property divisions demands that an allowance be made for the tax attributes of assets exchanged by the parties. A provision for the division of basis would provide such equity.

B. Basis in the Statutory Nonrecognition Exchange

The carryover basis approach of *Rouse* also diverges from the Code's model for other nonrecognition transactions. Where Congress has provided for nonrecognition treatment its approach to basis looks to each individual taxpayer's investment in property.[315] This model can be adapted to function both equitably and practically in a nontaxable division of marital property.

The basis rules adopted for statutory nonrecognition transactions track the taxpayer's investment in a continuing transaction in terms of the after-tax dollars committed to the investment. Basis begins with the taxpayer's original investment of capital, which presumably consists of after tax dollars.[316] Since this capital has already been included in gross income, the taxpayer is entitled to recover basis without additional tax cost. After a nonrecognition exchange, the taxpayer's initial investment remains committed to a continuing transaction. The basis of the property received therefore equals the basis of the property given up. Where gain is recognized because of the receipt of cash or boot, which is property in addition to the property identified as nonrecognition property, the basis of the nonrecognition property is increased to adjust for the added tax cost of the recognized gain.[317] Cash or boot received in such a transaction must also be allocated a basis. Thus, the basis of nonrecognition property is reduced

toward accepting a disproportionate property division as long as the disparity is not too great. *See supra* note 237 and accompanying text.

315. I.R.C. §§ 358(a)(1), 722, 1031(d) (1976). A different description of basis having the same effect is found in the last sentence of *id.* § 1033(b) and *id* § 1034(e). Note also that the Code is written in terms of the taxpayer's basis in property. Each taxpayer has a basis in property derived from cost measured in after-tax dollars. Basis is not an attribute of the property that follows an asset from taxpayer to taxpayer. This, however, is the approach of the *Rouse* rule.

316. This is based on a presumption that the taxpayer has filed tax returns properly accounting for capital in the hands of the taxpayer.

317. The basis of any property, including property acquired by purchase, can be described as the basis of the property given up in the exchange increased by gain recognized on acquisition or decreased by recognized loss. In a transaction where gain or loss is recognized, this formulation will equal the amount of money plus fair market value of property received, the statutory definition of amount realized under I.R.C. § 1001(b) (1976). *See* Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184, 188-89 (Ct. Cl. 1954). If a loss is recognized in a transaction subject to statutory nonrecognition rules, the basis rules provide for a reduction in the basis of nonrecognition property by the amount of the loss. This adjustment accounts for the tax savings produced by the loss. A recognized loss allows the taxpayer to receive other income free of tax cost. The receipt of this tax free income substitutes for recovery of the capital recognized as a loss. This recovery of lost capital requires a reduction of basis to account for a reduction of after-tax capital remaining in the continuing investment.

by the amount of cash and the fair market value of boot.[318]

This basis rule may be illustrated with a simple example. Assume that *A* exchanges property with a $1000 basis for property owned by *B* having a fair market value of $1200, which cost *B* $500. Neither *A* nor *B* recognize gain on the transaction. Using the substituted basis rules of statutory nonrecognition provisions, the basis of the asset received by *A* without recognition is the same as the basis of the asset given up, $1000. *A*'s after-tax investment in the old asset is *A*'s tax cost for the new asset. On disposition of this property, *A* is permitted to recover the $1000 basis without further taxable gain,[319] but must include any excess over that amount in gross income. Thus, on disposition of the new asset for $1200, *A* recovers the previously taxed investment of $1000 and pays tax on $200 of recognized gain. Similarly, *B* begins with an after-tax investment of $500, which becomes *B*'s basis for the property received from *A*. On disposition of the property for $1200 *B* recognizes $700 of gain. The Treasury is satisfied because appreciation or depreciation of both properties is accounted for on termination of the investment by each taxpayer. *A* and *B* are also treated fairly because deferred recognition of gain or loss is properly accounted for upon termination of their respective investments by comparing the after-tax dollars invested over the course of the whole transaction with the amount realized on final disposition. It is possible, however, to construct a model for this transaction that satisfies the Treasury but which fails to account properly for *A*'s and *B*'s investment.

If *A* receives *B*'s asset without adjustment in the basis of that particular asset so that *B*'s $500 basis carries over to *A*, the Treasury would receive its due on *A*'s sale for $1200. The full $700 appreciation of *B*'s asset is reported as income. But *A* is dissatisfied since he recognizes a gain of $700 despite the fact that he began with an investment of $1000 and only recov-

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318. Because cash is the measure of gain and loss, cash must have a basis equivalent to its face amount. Otherwise an exchange of cash for property, a purchase, would be a taxable event. Even when no gain is realized so that receipt of cash does not require recognition of gain, the basis of nonrecognition property is reduced by the amount of cash. This is, in effect, an allocation of basis to the cash in an amount equivalent to its face value. Similarly, property received in kind other than the nonrecognition property is allocated a basis equal to its fair market value. This accounts for the fact that gain is recognized to the extent of the fair market value of such other property. These rules are succinctly summarized in § 1031(d) of the Code, which provides:

> If property was acquired on an exchange described in this section, . . . then the basis shall be the same as that of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange. If the property so acquired consisted in part of the type of property permitted by this section, . . . to be received without the recognition of gain or loss, and in part of other property, the basis provided in this subsection shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange.

I.R.C. § 1031(d) (1976).

319. Gain is computed under *id.* § 1001(a) by subtracting adjusted basis from amount realized.

ered an additional $200 on completion of the investment. If carryover basis is also adopted on *B*'s side of the transaction, the Treasury recovers the $200 of appreciation on *A*'s original asset when *B* sells for $1200. *B*, however, recognizes only $200 of gain although she started with an investment of $500 and recovered $1200, an economic accession of $700. The unfairness of the latter approach, which shifts recognized income from *B* to *A*, is obvious. Nonetheless, this is the approach adopted by the courts for determining basis in a nontaxable division of community property.

Application of the statutory nonrecognition rule to determine basis following a division of marital property avoids the inequity of the current law. This approach is fairly straightforward. First, one-half of each retained asset represents the spouse's initial interest in that asset. There is no exchange with respect to this one-half. Thus, a spouse's basis in the retained one-half interest in each asset will be the same as the community's basis in that one-half interest, one-half of the basis of the whole. Second, each spouse exchanges a one-half interest in property given to the other spouse for that other spouse's one-half interest in retained property. Thus the husband gives up a one-half interest in property retained by the wife in exchange for the wife's one-half interest in property retained by the husband, and the wife does the same on her side of the transaction. Each spouse's basis for this one-half interest in property received from the other spouse is equivalent to that spouse's basis in property given up, one-half of the community basis of the property transferred to the other spouse. Lastly, each spouse's basis in retained property is increased by the amount of any gain recognized by the spouse and adjusted for any cash received to reflect an allocation of basis to cash in an amount equal to its face value. Thus, the husband's basis in his share of the community property is the sum of one-half of the community basis in retained assets, plus one-half of the community's basis in the assets received by the wife increased by gain recognized and decreased by the amount of money received. This rule equally divides community basis between the spouses.

Application of this proposal is easily demonstrated. Assume a marital community with two assets each worth $50. Pursuant to a marital property settlement, asset *A* is retained by the husband, asset *B* by the wife. Asset *A* was acquired during the marriage for $40 and asset *B* was acquired for $30. With respect to asset *A*, therefore, each party's after-tax investment is $20, one-half of the community basis. Each party's after-tax investment in asset *B* is $15. In the property division the husband retains his own $20 investment in asset *A* and gives up his $15 investment in asset *B*. Thus, the husband's post-settlement cost for asset *A* in terms of after-tax dollars is his initial $20 investment in asset *A* plus his lost investment in asset *B*, $15, for a total after-tax cost of $35. The wife's after-tax investment is $35, composed of her $15 initial investment in asset *B* plus her $20 investment in asset *A* retained by the husband.

Under the *Rouse* rule the husband's basis in asset *A* is $40, the carryover basis of asset *A* to the marital community. On a sale of asset *A* for $50, the husband recognizes a $10 gain and the Treasury would obtain tax on the full appreciation of asset *A* from its original cost of $40 to its sale price of $50. The husband obtains a credit for $5 of after-tax investment that he never made since his total investment was only $35. He obtains that credit from the wife who, on a sale of asset *B* for $50, will pay tax on the $5. (See Table III.) The wife's basis in asset *B* under the *Rouse* rule is only $30, the community basis. Thus the wife's basis in asset *B* is $5 less than her tax cost, her after-tax investment. On a sale of asset *B* for $50 the wife recognizes $20 of gain. Again the Treasury receives a tax on the full appreciation of asset *B*. The wife, however, is only allowed to recover $30 of her $35 after-tax investment. Five dollars of taxable gain has been shifted from husband to wife. The supposedly equal division of marital property is unequal to the extent of the added tax burden borne by the wife.

TABLE III

	FMV of property received	Cost in after-tax dollars: Retained interest	+	Interest transferred	*Rouse* basis	Increase (Decrease)
Husband (asset *A*)	50	20	+	15 = 35	40	5
Wife (asset *B*)	50	15	+	20 = 35	30	(5)
TOTAL	100			70	70	0

The basis rules for statutory nonrecognition transactions avoid the disparity created by the *Rouse* rule. The husband's basis in asset *A* would be $35, the sum of the basis of his retained one-half interest in asset *A* plus the basis of property given up in exchange for the wife's interest in *A*, which is the husband's one-half interest in asset B with a basis of $15. This basis would be increased by any gain recognized and decreased by any cash or separate property received from the wife. The husband's $35 basis in asset *A* is equivalent to his after-tax cost for the property, his one-half share of the community's original cost plus his share of the after-tax investment in asset *B* transferred to the wife. The wife's basis in asset *B* would also be $35, her share of the initial investment in *B*, $15, plus her basis in the property given up, which is her one-half of the community basis of asset *A* with a basis of $20. Note that each spouse's $35 basis is equivalent to one-half of the marital community's total basis in its community assets. Basis is neither created nor destroyed. The Treasury again obtains tax on the full appreciation of assets *A* and *B* on their respective sale, $15 of recognized gain by the husband on his sale of *A* for $50, and $15 of recognized gain by the wife on her sale for $50. The burden of recognized gain borne by each party is measured by the difference between the amount realized by each individual, and that individual's own after-tax investment in the property. The end result is an equal division of tax cost.

This approach also reaches a sound result where gain is recognized because of a bargain and sale or the receipt of separate property by a spouse. The property division in *Carrieres v. Commissioner*[320] serves as a complex but instructive vehicle for analyzing this proposition.

Carrieres is one of the leading authorities on division of community property. The case also provides an example of the difficulty encountered in applying the *Rouse* basis rule to a complex transaction. Unfortunately, the Tax Court opinion fails to grapple with the basis issue and does not provide figures for the community basis of the Carriereses' property. We must, therefore, use hypothetical numbers. Assume that the property division was as follows:

TABLE IV

Asset	Community basis	FMV (net of encumbrance)	Value retained by Jean	Value retained by George
Cash		$ 30,300	$ 28,300	$ 2,000
Rental property	$ 20,000	55,000	27,500	27,500
Life insurance	5,000	7,400	7,400	
Household furniture	5,000	3,500	3,500	
Unimproved lots	10,000	23,700	25,000	
Encumbrance			(1,300)	
Family residence	10,000	27,100	35,000	
Encumbrance			(7,900)	
Stock	100,000	241,000		241,000
SUBTOTAL	$150,000	$388,000	$117,500	$270,500
Separate cash from husband			76,500	(76,500)
TOTAL			$194,000	$194,000

To equalize the property division George gave Jean an additional $76,500 of cash from his separate property. As noted earlier, the Tax Court held that Jean received $120,500 of property in exchange for her interest in the stock of a family business.[321] Jean was required to recognize gain to the extent she exchanged an interest in her community property for George's separate property. Thus Jean recognized $76,500/$120,500, or 63.5%, of her realized gain. If the community basis for the stock was $100,000, Jean's basis for her one-half interest would be $50,000. Her realized gain on the exchange would be $70,500 ($120,500-

320. 64 T.C. 959 (1975), *acq.* 1976-2 C.B. 1, *aff'd per curiam*, 552 F.2d 1350 (9th Cir. 1977).

321. *Id.* at 968. The $120,500 is a net figure that ignores encumbrances on real estate received for Jean's interest in the stock. The transaction may be explained by including the full value of the property received in amount realized and adding the cost to Jean of satisfying George's share of the liabilities to the basis of the property given up in the exchange. The resulting realized gain would be the same under either approach. Regulations regarding the role of liabilities in a like-kind exchange adopt the latter approach. Treas. Reg. § 1.1031(d)-2 ex. 2.

$50,000). She would recognize approximately $44,750.[322]

Applying the *Rouse* basis rule dictates that Jean received community assets with a carryover basis of $40,000, the community basis in assets she retained, plus cash of $104,800. Her total basis in the property received, including the cash, is $144,800. Using our hypothetical numbers, her after-tax investment in this property consists of: (1) her share of community basis in retained property including one-half of the community cash, $40,150; (2) the basis of her interest in the stock transferred to George, $50,000; (3) the tax cost to her of $44,750 of recognized gain; and (4) the cost of paying George's share of the community debt encumbering real property, $4600. This total after-tax investment of $139,500 is $5300 less than the basis she obtains under the *Rouse* rule. Jean will be allowed to sell her property and receive $5300 of gain tax-free.

George's basis is more difficult to ascertain under *Rouse*. For the partitioned real estate, he receives his one-half of the community basis. For the stock, he is first credited with the basis of his own one-half interest, $50,000. The Tax Court's allocation device in *Carrieres* suggests that George acquired the other one-half interest in the stock for $76,500 of separate property in a taxable purchase, and $44,000 of community property in a nontaxable property division. $44,000/$120,500, or 36.5% of Jean's interest was therefore acquired in a tax-free division of community property. Under *Rouse*, 36.5% of Jean's basis in that interest, $18,250, carries over to George.[323] The remaining 63.5% of Jean's interest was acquired by purchase, giving George a $76,500 cost basis. His total basis for the stock is $144,750 ($50,000 + $18,250 + $76,500).

The approximately $5300 of tax-free basis obtained by Jean comes at the cost of lost basis on George's side of the transaction. George's total basis in retained property under *Rouse*, including cash and the partitioned rental property, is $156,750. George's after-tax cost for this property includes his basis in the partitioned real estate of $10,000, $2000 of retained community cash, his original basis for one-half of the stock, $50,000, his share of the community basis of the assets retained by the wife, $15,000, the excess community cash he transferred to the wife, $13,150, and the cost of the settlement in the husband's separate cash of $76,500. This after-tax investment is reduced by George's share of the community liability en-

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322. The rule suggested earlier in this Article would require Jean to recognize gain to the extent of cash in excess of her share of community cash. Jean received a total of $104,800 in cash. Her share of the community cash was $15,150. She thus exchanged an interest in the stock, the only community asset she relinquished, for $89,650 of cash. Since the cash exceeded her realized gain of $70,500, Jean's gain would be recognized in full. If Jean's gain is fully recognized, the transaction is essentially a taxable sale of her community property interests.

Recognition of this gain would be reflected in Jean's basis. Her basis in retained community property, other than the partitioned real estate, would consist of her one-half share of the community basis, $30,150, plus the basis of property transferred to George, $50,000, George's share of indebtedness encumbering property received by Jean, $4600, increased by her $70,500 of recognized gain, and decreased by the $89,650 of cash. Her basis in retained property would be $65,600.

323. *See* Bost & Kimball, *supra* note 231, § 35.02[2], at 35-10.

cumbering Jean's property, $4600, which he is no longer required to pay. The total, $162,050, exceeds the husband's basis in retained property, $156,750, by $5300.

TABLE V

Jean Carrieres's Basis

	Rouse Basis	Tax Cost	
Community basis in retained property	$ 40,000	1/2 community basis in partitioned real estate	$ 10,000
		1/2 community basis in retained assets	15,000
		Assumption of George's share of community liability	4,600
		1/2 of community cash	15,150
Community cash received	28,300	1/2 community basis in stock given to husband	50,000
Cash from husband	76,500	Gain recognized	44,750
	$144,800		$139,500

TABLE VI

George Carrieres's Basis

	Rouse Basis	Tax Cost	
Partitioned real estate	$ 10,000	1/2 community basis in partitioned real estate	$ 10,000
Retained community cash	2,000	1/2 community basis in retained stock	50,000
Stock - portion obtained in tax-free division	68,250	1/2 of community cash	15,150
Purchased portion	76,500	1/2 of community basis of assets given to wife	15,000
		Separate cash to wife	76,500
		Release from community liability	(4,600)
	$156,750		$162,050

A more equitable division of basis, reflecting the tax cost of the property division to each party, would be achieved by employing the substituted basis rules of statutory nonrecognition transactions. The analysis begins with George's side of the transaction. George relinquished his interest in community property plus cash in exchange for his wife's interest in stock and a release of his share of the encumbrances on real property. George realized the fair market value of Jean's interest in the stock, $120,500, and the release of his share of community indebtedness, $4600. He gave up his one-half interest in the community assets retained by Jean with a basis of $15,000. He also transferred $13,150 out of his share of community cash and an additional $76,500 of cash that was his separate property. He thereby realized a gain of $20,450 ($125,100-$104,650), none of which was recognized.

Under the substituted basis proposal, George's basis in the stock equals the basis of his retained one-half interest, $50,000, plus the basis of property given up, $104,650. This basis is reduced to account for George's share of the encumbrances in property taken by Jean, $4600.[324] Since George did not receive any of Jean's share of community cash nor recognize any gain, there is no further adjustment to his basis. George's basis in the retained property is shown in Table VII.

TABLE VII

George's Substituted Basis

Basis of retained community cash		$ 2,000
Basis of partitioned rental property		10,000
Basis of stock:		
Retained interest	$ 50,000	
Basis of property given in exchange for Jean's interest in stock		
1/2 basis of assets retained by Jean	15,000[325]	
George's share of community cash given to Jean	13,150	
George's separate cash given to Jean	76,500	
Release of indebtedness	(4,600)	
		150,050
Total basis		$162,050

Jean's basis in her property is the sum of the basis of her retained one-half interest in community property, her share of community basis in property transferred to George, and the basis of future cash needed to satisfy George's share of encumbrances on Jean's property, increased by gain rec-

324. *Cf.* I.R.C. §§ 358(d) (Supp. V 1981), 1031(d) (1976) (assumption of liability in tax-free exchange treated as money received by other party in amount equal to liability or encumbrance to which property is subject).

325. This figure is one-half of the sum of the community basis in property received by Jean. *See* Table IV *supra* p. 994.

ognized, decreased by cash received in excess of her share of community cash. This computation is shown in Table VIII.

TABLE VIII

Jean's Substituted Basis

Basis for retained interest in community assets:[326]			
Partitioned rental property	$ 10,000		
1/2 of community cash	15,150		
Life insurance	2,500		
Household furniture	2,500		
Unimproved lots	5,000		
Family residence	5,000		
			$ 40,150
Basis of interest obtained from George			
Basis in property given up:			
Stock	$ 50,000[327]		
Cost of satisfying George's share of liabilities	4,600[328]		
Increased by the gain recognized	44,750		
		99,350	
Decreased by the cash received			
George's share of community cash	$ 13,150		
Separate property cash from George	76,500		
		(89,650)	
Total basis for allocation to George's share of assets retained by Jean			9,700
Basis allocated to separate and community cash from George			89,650
Total basis for assets retained by Jean			$139,500

The net result of this basis determination is that each spouse receives one-half of the community basis with an appropriate adjustment for gain

326. This figure represents one-half of the marital community's basis in each asset.
327. This figure represents Jean's one-half share of the $100,000 community basis in the stock.
328. Jean's basis is increased by only one-half of the community liability. The other one-half of these encumbrances is already reflected in Jean's one-half share of the community basis in other assets.

recognized and additional money or property added to the pot. The total community basis for the property was $150,000 plus community cash of $30,300. One-half of the total is $90,150. Jean's share of this $90,150, increased by her $44,750 of recognized gain and future payments of George's $4600 share of community liabilities, is $139,500, the equivalent of the basis determined by substituting the basis of property Jean gives up, increased by recognized gain, for the basis of the assets she retains. George's $90,150 share of the community basis, increased by the additional cash he transferred to Jean, $76,500, and decreased by his $4600 release from community liabilities, is $162,050. Again this is equivalent to the basis derived by substituting the basis of George's interest in community property given up, plus the separate property cash he contributed, for his basis in community property. Thus, an equitable division of basis is constructed that accounts for the tax cost to each spouse of retained property. The result is achieved by giving each spouse one-half of the community basis for retained assets plus the spouse's basis in assets given up, increased by gain recognized, and decreased by cash received in excess of the spouse's share of community cash and adjusted for community liabilities.

VI. Allocation of Basis

The principal difficulty with the substituted basis approach lies in its requirement for an allocation of basis in every case to which it is applied. The problem of allocation is not insurmountable, however; similar issues of allocation arise under the *Rouse* rule whenever gain is recognized with respect to more than one asset, or whenever an exchange of separate property for several community assets takes place.[329]

There are three distinct elements to the substituted basis of property retained by a spouse in a community property division: (1) the spouse's basis for the retained interest in each asset; (2) the substituted basis derived from the spouse's basis in community assets transferred to the other spouse; and (3) basis adjustments required by the recognition of gain, release of liabilities, the receipt of excess cash, or the payment of cash or separate property to equalize the division. The first of these elements requires no allocation. Each asset retained by a spouse will keep the basis of that spouse's community interest in the property, which is one-half of the community basis. The second and third elements are combined into a single figure by the substituted basis rule. The substituted basis for one-half of the property retained is equivalent to the basis of the spouse's interest in property given up increased by gain recognized and decreased by any cash received, including liabilities treated as cash. This amount must be allocated. Following the approach adopted in other nonrecognition situations,

329. For example, if the court had concluded in *Carrieres* that Jean had sold several assets for George's cash payment, her recognized gain would be allocated among the several assets. Likewise, had George exchanged cash for his wife's interest in several community assets, the additional basis generated by the cash payment would require a method of allocating basis to each of these assets.

the allocation is logically based upon the relative fair market values of assets retained by the spouse.[330] This allocation reflects the proportionate exchange of value for the retained interest in each asset.

The relative ease of the allocation process is demonstrated by the *Carrieres* setting. Jean's share of the community basis in her retained community assets was $30,150. In addition, after allocating an appropriate amount of her total substituted basis of $99,350 to the cash received, $9700 of basis remained to be allocated to retained property.[331] Of this amount, $4600 represents encumbrances on specific assets and may thus be allocated as part of the cost of those specific properties, $650 to the unimproved lots, and $3950 to the residence. That leaves $5100 of substituted basis to be allocated in proportion to value as shown in Table IX.

TABLE IX

Asset	FMV	1/2 of community basis	Substituted basis from transferred assets		Total basis
Life insurance	7,400	2,500	(5,100) (7,400/61,700)=	$ 612	$ 3,112
Household furniture	3,500	2,500	(5,100) (3,500/61,700)=	289	2,789
Unimproved lots	23,700	5,000	(5,100) (23,700/61,700)=	1,959	
			plus 1/2 of encumbrance	1,300	8,259
Family residence	27,100	5,000	(5,100) (27,100/61,700)=	2,240	
			plus 1/2 of encumbrance	3,950	11,190
Rental property	$27,500	$10,000			10,000
				$5,100	$35,350

Note that the basis increase resulting from Jean's recognized gain on the receipt of cash from George is automatically allocated to the cash by the reduction in the basis of other property in the amount of the cash. The reduction for cash in the substituted basis rule is simply an allocation of basis to cash in an amount equivalent to the face value of the money.[332] The same accounting occurs on George's side of the transaction. The basis of property given up by George includes the cash transferred to Jean, an amount equivalent to George's basis for his interest in cash. A corollary to this rule allocates basis if gain is recognized because of an in-kind exchange of separate property. The separate property received by a spouse in exchange for an interest in community property would be given a basis equal to its fair market value to account for the gain recognized, and thus

330. *See, e.g.*, Treas. Reg. § 1.358-2(a)(2)-(3) (allocating basis on receipt of two or more classes of stock or securities in tax-free corporate reorganization).

331. *See* Table VIII *supra* p. 998.

332. *See supra* note 318.

the tax cost of the receipt of the other spouse's separate property in a taxable exchange.[333]

A. Personal Use Assets

The presence of depreciated personal use property creates an additional difficulty under the substituted basis approach. Dividing community basis could allow a spouse to allocate unrecoverable basis in personal use assets to business or investment property.[334] For example, in determining George's basis in the stock (see Table VI), his one-half of the community basis in household furniture was included in the basis of property given up. This basis was allocated to the stock. The household furniture had a basis greater than its fair market value. On a sale of the furniture, no loss deduction is allowed because of the personal nature of the property.[335] The basis allocated to George's stock from his interest in the household furniture becomes recoverable, however, on a sale of the stock. Unrecoverable basis in a personal use asset has thus been coverted into recoverable basis in an investment asset.[336]

The problem may be overstated, however, at least with respect to its impact on revenue. Whenever an allocation of basis from personal use assets to income producing property[337] occurs, there will be a corresponding allocation of basis from the same income producing property to personal use assets on the other side of the transaction. For example, in the *Carrieres* hypothetical $289 of Jean's substituted basis from the stock and her recognized gain was allocated to the household furniture, and $2240 of her substituted basis was allocated to the personal residence.[338] In this case substantially more basis is allocated from income producing property to personal assets than is allocated in the other direction.[339]

333. If, as recommended, the receipt of separate property in exchange for community property is allowed without recognition of gain, see *supra* text following note 262, the separate property would receive an allocation of basis in proportion to fair market value in the same manner as the other nonrecognition property received in the exchange.

334. *See* Hjorth, *supra* note 180, at 267.

335. *See* I.R.C. §§ 165(c) (West Supp. 1983), 262 (1976).

336. The basis of the furniture exceeded fair market value by $1500. If the furniture were sold for its fair market value this $1500 of basis could not be recovered with a loss deduction. *Id.* § 165(c) (West Supp. 1983). George's $750 share of this unrecoverable basis was allocated to his basis in the stock.

337. Property held for use in a trade or business or for the production of income. *See, e.g.*, I.R.C. § 1231 (1976 & Supp. V 1981); Wood v. Commissioner, 276 F.2d 586 (5th Cir. 1960).

338. *See* Table IX *supra* p. 1000.

339. Note, however, that the value of personal use assets to which this basis is allocated exceeds their respective bases, so all of the basis in the depreciated furniture would be recovered on an immediate sale. That basis will be allocated in other cases from income producing property to personal property in a manner that will increase the unrecoverable basis to the parties is equally possible. This situation would occur, for example, where one spouse receives investment property with a basis to the community in excess of its value and the other spouse receives personal use assets that have also declined in value below cost. Although individual taxpayers may obtain some benefit from the transfer of basis from personal use assets, other will lose basis. The cost to the Treasury may tend to even out over time.

At the cost of added complexity in the allocation process, the problem may be avoided by limiting the basis of personal use assets to fair market value on the date of the property division in computing substituted basis. The Service took this approach in Revenue Ruling 74-347.[340] If this scheme were adopted, the basis of the property given up by George in the *Carrieres* hypothetical would be reduced by $750, his share of the excess of the basis of the furniture over its value. Accordingly, George's basis in the stock would be reduced to $161,300. If this adjustment is made, equity also requires that none of the substituted basis resulting from a spouse's interest in income producing property, recognized gain, or additional consideration paid be allocated to depreciated personal use property in excess of its fair market value.[341]

B. Allocation to Business Assets

An additional question about the substituted basis approach arises where assets of different character are involved in a complicated property settlement. Where the marital property includes the assets of a sole proprietorship retained by one of the spouses, the other spouse's basis in business assets will be allocated to nonbusiness assets and, conversely, the spouse retaining the business will allocate his or her basis in nonbusiness assets to assets retained as part of the business. Inventory and unrealized receivables present the most significant problem. Where a spouse gives up high basis capital assets in exchange for inventory or receivables, the basis of the capital asset allocated to inventory or receivables reduces the ordinary income otherwise produced by such assets. Conversely, a reduction in basis in these assets, caused by an allocation of substituted basis in an amount less than one-half of the community basis in such assets, imposes an undue tax burden.

The problem might be resolved with a return to the *Rouse* rule in this one instance to require that the community basis of receivables and inventory carries over to such assets.[342] The basis of these assets will be increased only by recognized gain attributable to the receivables or inventory. If a spouse's substituted basis for receivables or inventory would be less than the community basis, basis allocated to other assets will be reduced by the excess of the community basis in inventory and receiv-

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340. 1974-2 C.B. 26; *see also* Hjorth, *supra* note 180, at 268 (example of effects of Revenue Ruling).

341. This allocation would require three steps. First, a determination must be made that an allocation of the basis of relative fair market values would result in assigning a basis to personal use assets in excess of the fair market value of any such asset. Second, basis must be allocated to the personal use assets to the extent of fair market value. If the spouse's basis in his or her one-half interest in the personal use asset exceeds the value of that asset, no additional basis would be allocated to the asset. Finally, basis remaining after allocation to depreciated personal use assets would be allocated to other assets in proportion to fair market value.

342. This approach is the one taken with respect to distributions of inventory and receivables to a partner in complete liquidation of the partner's partnership interest. I.R.C. § 732(b)-(c) (1976).

ables over the recipient spouse's substituted basis for these assets. If a spouse receives only inventory or receivables, the spouse's substituted basis in excess of the community basis of the inventory or receivables may be allocated to other property belonging to the spouse, or be allowed as a loss on the exchange of the marital property.[343]

Similar characterization issues are encountered if substituted basis from capital assets is allocated to depreciable property. Where a spouse exchanges personal use property or capital assets for an interest in depreciable property, either an allocation of substituted basis from the capital assets to depreciable property occurs, or the recipient is allowed to allocate basis to assets not involved in the exchange, hold the basis in abeyance, or recognized a capital loss. The first of these alternatives is preferable. The spouse is exchanging property in which he has an investment in after-tax capital for the retained depreciable property. The investment in the property given up is a true tax cost for the property retained. While the taxpayer did begin with an investment in nondepreciable property and end with depreciable property, a cost has been incurred that should be recoverable as if that cost were a direct purchase. The taxpayer's after-tax capital has been converted into an investment in depreciable property. The same conversion may occur in a like-kind exchange of unimproved land for depreciable improved real estate, or on conversion of personal property to a business use.[344]

If this reallocation of basis among assets of differing character is deemed insurmountably difficult, a method of allocation could be used that is analogous to the pattern of Treasury Regulation section 1.755-1, which accounts for certain basis adjustments in the partnership area.[345] Marital assets may be divided into four categories, (1) personal use assets, (2) section 1221 assets held for investment, (3) section 1245 and 1250 assets (depreciable property), and (4) inventory and receivables. The substituted basis of property given up by a spouse in each category may be allocated to assets of the same nature retained by the spouse. The allocation would be in proportion to the value of assets in each category.[346] If the spouse does not receive assets in the same category as assets given, basis may be allocated to assets in the next category in ascending order. An alternative closely following the Treasury Regulations would hold basis in abeyance until the spouse acquires property of like character to which basis may be allocated. Although this scheme would allocate basis recoverable as deductions against ordinary income to similar property first, the added complexity is not justified by the limited scope of the problem.

343. *See id.* § 731(a)(2).

344. *Id.* § 1031; *see* Treas. Reg. § 1.1031(a)-1(c).

345. Treas. Reg. § 1.755-1.

346. Allocation by value reflects the proportionate amount exchanged for each retained asset.

VII. CONCLUSION

The proposals in this Article may add complexity to what some consider settled rules of easy application. The ease of application exists, however, only because the authorities have avoided difficult basis problems created by the current approach. The existing law is neither easy to apply nor settled for a spouse negotiating a complex marital property division who is faced with the inequity inherent in the current approach to marital property divisions. The various proposals discussed in this Article lose much of their complexity when they are read together and apart from their theoretical justification. There is value, therefore, in summarizing the proposals in this conclusory section.

Existing rules for the treatment of spousal support would remain for periodic and contingent payments. The recipient currently includes those payments in gross income and the payor receives a deduction. Installment payments of a fixed sum payable over a minimum period of time considerably less than the current ten-year period, preferably over thirty-six months, should be the subject of an election to treat payments as support subject to sections 71 and 215. The election would require the consent of both spouses filed with the spouse's individual tax returns for the taxable year of divorce. If no election is filed installment payment of an ascertainable sum would be treated the same as a lump sum payment of cash for a release of marital rights.

If cash payment is made to secure a release of marital rights, taxation should depend upon the nature of the interest given up in exchange for the principal sum. If the payments are in exchange for the inchoate marital rights of a spouse in a common law state, as under current law, the status nature of those rights should be recognized and the payments received tax free without any adjustment to the income of the payor. If the payments are in exchange for an interest in property, regardless of vesting, the cash payment would be received in exchange for a disposition of that property interest. Gain should be recognized to the extent a spouse receives cash in excess of his or her basis in the marital property given up. Identification of the spouse's vested property interest serves to identify the basis of assets given up by the spouse. For example, a wife may have a dower or other future interest in one-third of her husband's property for which she receives a cash payment. She exchanges her interest in this property for cash and recognizes a gain in the amount by which the cash exceeds the basis of property in which she has an interest. The husband who purchases the wife's interest in this property should obtain a basis increase to reflect his cash cost. A spouse would share in the basis of assets subject to division on divorce in the proportion in which the spouse may share in the value of the marital property. In the case of an installment payment of a principal sum, the recipient's gain could be deferred under the installment sales rules of section 453.

One difficulty inherent in this approach lies in distinguishing between payment for release of status rights, such as lump sum alimony, and payment in exchange for a release of an interest in property. This requires an investigation of varying state laws and the intent of the parties. The principal question, answered under a federal standard, should be whether the spouse has a right to property under state law that is extinguished with the cash payment. Finding an exchange of cash for release of a property interest is made easier if one recognizes that a divorcing couple who intend cash payments as support can elect section 71 treatment for installment payment of a principal sum. Under this proposal the beneficiary of support would be taxed at ordinary income rates. The seller of an interest in property would be taxed at capital gain rates with a basis adjustment for the purchasing spouse. In both cases the recipient of the economic benefit of cash bears the tax burden.

In-kind division of property on divorce should be treated as a tax-free exchange. This proposal treats the wife in a common law state who has no vested property interest as exchanging her bundle of legal interests in the husband's property for the property transferred to her outright. She receives a portion of the husband's estate equivalent to the value of her marital rights in the husband's existing and future assets. The common law wife would also receive an interest in the marital community's after-tax investment in those same assets. She shares in the basis of assets in the husband's estate in the same proportion as the value of her marital rights bears to the estate subject to the jurisdiction of the divorce court. This proportionate share of basis can be used whenever it is necessary to determine gain realized on the exchange. The wife's amount realized equals the value of property received by her for release of her property rights. The basis of property given is her proportionate share of the basis of the estate subject to the jurisdiction of the divorce court. The treatment of the common law wife suggested here is similar to the concept of the marital property asserted by some commentators. It treats the wife as possessing an interest in the marital property in the proportion assigned to her under state law. Unlike the treatment of marriage as an equal partnership, this proportionate approach pays homage to the distinctions between the spouse's rights in community property and noncommunity property jurisdictions, however ill-advised those distinctions may be in contemporary society.

As in other nonrecognition transactions, the receipt of cash in exchange for property should generate recognized gain to the spouse who cashes out of an interest in property. The receipt of a spouse's proportionate share of the marital community's cash would not be treated as an exchange of cash for property. In addition, the receipt of cash as a substitute for future support may go unrecognized as status gain. The husband who exchanges property for a release of the wife's marital rights should likewise be permitted to treat this as a nonrecognition exchange, thus overruling *United States v. Davis*.

Identical nonrecognition treatment should be provided to divisions of community property. No gain or loss would be recognized on a in-kind exchange of community property for other property pursuant to divorce. This nonrecognition principle extends to an exchange of a spouse's separate property for an interest in community property. There is no sound reason to treat the in-kind receipt of separate property differently from an exchange of community assets. Allowing the use of separate property vastly simplifies the process of negotiating an equal property settlement.

Gain should be recognized to the extent that a spouse receives cash in excess of the spouse's share of community cash. This principle recognizes that the receipt of excess cash represents a termination of the spouse's investment or ownership of property and is, therefore, an appropriate occasion for taxation. Similarly, gain should be recognized to a spouse released from community indebtedness in excess of the spouse's basis in community assets.

Consistent with basis rules applied in other nonrecognition transactions, the basis of property received by a spouse on division of marital property in divorce should equal the spouse's pre-divorce share of basis in the marital property received plus the spouse's basis in property given up, increased by gain recognized, and decreased by cash received, including a release of indebtedness treated as the receipt of cash. This basis rule is the equivalent of giving each spouse his or her share of the marital community's basis in marital property, increased by any gain recognized on the transaction and the increased cost to a spouse who must invest additional property in the settlement.

In a common law property division, or a community property division where an unequal division occurs because of factors other than property ownership, the basis given up would equal the spouse's proportionate interest in the marital property as determined by the divorce court. Thus a spouse receiving forty percent of the total estate subject to the jurisdiction of the divorce court would be deemed to have a basis of forty percent of the total assets and forty percent of each separate asset, subject to division by the court. The substituted basis determined from the basis of the property interest relinquished by a spouse is allocated first to cash received by the spouse and then to property in proportion to value. If the basis rule is formulated in the terms of existing statutory nonrecognition provisions, the allocation to cash is automatic under the statutory language. If the basis rule is formulated in somewhat simpler language giving each spouse his or her pre-divorce share of basis, provision for allocation of basis to cash must be included in the allocation rules.

The basis rules might also establish some standards for allocation of substituted basis to assets of different character. The use of basis from personal use assets might be limited to the fair market value of such assets at the time of divorce. The basis of inventory and unrealized receivables would remain unchanged in recognition of the ordinary income character of such assets. Otherwise, basis should be allocated to assets in proportion to value.

Finally, as a concession to unnecessary complexity that may be created by the application of these proposals to a simple property division involving few assets, the Code could provide an election to use carryover basis in limited circumstances, applying the substituted basis rule only to parties with substantial assets. These proposals would add a large measure of rationality and fairness to the division of property upon divorce.